

BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of the)
Application regarding the)
Conversion and Acquisition)
of Control of Premera Blue) Docket No. G02-45
Cross and its Affiliates)
)
)
)

Adjudicative Hearing
May 10, 2004
Day 5
(Pages 989 to 1225)
Tumwater, Washington

Taken Before:

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P R O C E E D I N G S

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JUDGE FINKLE: Ready to proceed?

4

MR. KELLY: Yes, we are. Our first witness is
Audrey Halvorson.

6

MR. HAMJE: Your Honor --

7

JUDGE FINKLE: Yes? Let me swear the witness.

8

AUDREY HALVORSON, having been first duly
sworn by the Judge,
testified as follows:

10

11

JUDGE FINKLE: Please sit down.

12

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16

MR. HAMJE: Your Honor and Commissioner, I just
wanted to let you all know that we have someone here today
over on the right of me - to the right of me, who will be
videotaping the testimony of both Ms. Halvorson and
Mr. Fahey.

17

JUDGE FINKLE: Okay. No objection to that?

18

MR. KELLY: No problem whatsoever.

19

20

DIRECT EXAMINATION

21

22

BY MR. KELLY:

23

Q Okay. Would you state your name?

24

A Audrey Lynn Halvorson.

25

Q And what is your position at Premera?

1 A I'm a senior vice-president and chief actuary at Premera
2 Blue Cross.

3 Q Let me ask you to describe your educational background?

4 A I have a bachelor's of business administration in actuarial
5 science from the University of Wisconsin.

6 Q Are you an accredited actuary?

7 A I am. I am a member of the American Academy of Actuaries as
8 well as a fellow of the Society of Actuaries.

9 Q And do you meet the continuing education requirements of the
10 American Academy of Actuaries?

11 A Yes, I do.

12 Q Would you describe for us your professional career?

13 A From 1982 to '84 I worked at Hartford Insurance Group in
14 Hartford, Connecticut. In 1984 until July of 2000 I was
15 with Milliman and Robertson. And in July of 2000 I joined
16 Premera as a vice-president of actuarial services. In April
17 2001, I was promoted to my current position.

18 Q Okay. Now, did your work at Milliman include work on
19 healthcare and insurance matters?

20 A Yes, it did. I started at Milliman in the Hartford,
21 Connecticut, office and there I worked with insurance
22 companies, health maintenance organizations doing reserving,
23 HMO premium development, did a lot of disability reserve. I
24 worked on a sale of a block of disability insurance as well
25 as a demutualization of a mutual health insurance company.

1 I then moved in 1991 to the San Francisco office of
2 Milliman and there I worked with HMOs, insurance companies,
3 Blue Cross/Blue Shield organizations, Managed Medicaid
4 Organizations. And I was doing reserves, disability product
5 work, premium rate development and - among other things.

6 Q So full range of actuarial services?

7 A Full range of things. And in 1994 I moved up to the Seattle
8 office with Milliman. And there I worked also with
9 insurance companies and Blue Cross/Blue Shield
10 associations - or organizations.

11 And HMOs, I worked with physician-owned HMOs as well as
12 hospital-owned HMOs, integrated delivery systems and one
13 medical device company as well. And I did reserving and
14 premium rate development work there as well as the standard
15 stuff, capitation work, reimbursement arrangement
16 development, incentive arrangement development for
17 providers.

18 And also an interesting thing I did was work with - to
19 develop a risk-based capital leasing arrangement with
20 re-insurance companies for provider-owned HMOs.

21 Q Now, could you describe any actuarial committees that you
22 have been a member of during your career?

23 A Yes, I was a member of the American Academy of Actuaries
24 committee that developed the standards of practice for
25 continuing care retirement communities. As well, I worked

1 on the Society of Actuaries Futurism Section Council.

2 Q Are you doing any work now that relates to standards for the
3 National Association of Insurance Commissioners?

4 A Yes, I am. I'm on the American Academy of Actuaries
5 committee called a Health Equity Work Group that is
6 developing equity requirements for the NAIC for health
7 insurance companies.

8 Q Would you describe any publications that you have
9 authorized?

10 A Well, at Milliman I wrote two research reports, one called
11 "Risk-based Capital for Managed Care Organizations" and one
12 named - with the title "Acuity Severity Inpatient Hospital
13 Reimbursement Arrangements."

14 I also at Milliman wrote a chapter of a book called -
15 the book was called "Thriving in Capitation" and the chapter
16 was called "Global and Professional Capitation."

17 And then while at Premera I wrote a chapter of the
18 "Group Insurance" book and the chapter was called
19 "Prescription Drug Benefits."

20 Q Okay. Could you give us an overview now of your duties as
21 senior vice-president and chief actuary at Premera?

22 A Yes. I am responsible for five departments at Premera: The
23 corporate actuarial area, the MBS actuarial area, the RND
24 actuarial area, the financial planning and analysis unit as
25 well as the business information services unit.

1 My responsibilities include reserving, premium rating,
2 research on new risks, financial projections and budgeting
3 as well as the business side of our data warehouse
4 development and data mining.

5 Q Let's turn to your prefiled testimony. Your prefiled direct
6 and responsive testimonies have been served and filed in
7 this proceeding. Do you adopt that testimony?

8 A Yes, I do.

9 MR. KELLY: And Ms. Halvorson's prefiled direct has
10 been marked as Hearing Exhibit P-82 and her responsive
11 testimony is P-83 and with her adoption of that testimony,
12 Premera moves to admit those exhibits.

13 MR. HAMJE: No objection.

14 MS. HAMBURGER: No objection.

15 JUDGE FINKLE: Admitted.

16 Q (BY MR. KELLY) Okay. Now, there has been some discussion
17 at the hearing about premiums for the individual and small
18 group lines of business. Please tell us what Premera's
19 position is as to whether there will be any impact on
20 premium rates for the individual and small group lines as a
21 result of the conversion itself.

22 A There will be no impact on the premium rates in individual
23 and small group insurance as a result of the conversion.

24 Q Well, to be more specific, what is Premera's position as to
25 whether as a result of the conversion there will be a

1 premium rate change in Eastern Washington in the individual
2 or small group lines over whatever might otherwise occur if
3 there is no conversion?

4 A There - Premera's position is that there will be no increase
5 in the premium rates in Eastern Washington in individual and
6 small group due to the conversion.

7 Q Now, what about Premera's view as to whether as a result of
8 the conversion there will be a premium rate change in
9 Western Washington in those two lines over what might
10 otherwise occur if there was a conversion?

11 A Premera's position is that there will be no change in the
12 premium rates in Western Washington in small group or
13 individual as a result of the conversion.

14 Q And following down that line, what is Premera's view as to
15 whether as a result of the conversion there will be any
16 change in the total average premium rate for those two lines
17 over what might otherwise occur if there is no conversion?

18 A Premera's position is that there will be no change in the
19 total average premium in all of Washington in individual and
20 small group as a result of the conversion.

21 Q You know, we have gone through the premium - the premium
22 question. Let me turn now to margins.

23 As a result of the conversion, will there be a change in
24 Eastern Washington in the margins for the individual and
25 small group lines over whatever the margins might otherwise

1 be if there is no conversion?

2 A Premera's position is that there will be no change in the
3 margins in Eastern Washington in individual and small group
4 as a result of the conversion.

5 Q And turning to Western Washington, as a result of the
6 conversion will there be a change in Western Washington in
7 the margins for those two lines over whatever the margins
8 might otherwise be if there were no conversion?

9 A Same thing; no change expected in Western Washington in the
10 margins due to the conversion.

11 Q What about the overall margin rates - overall margins - I'm
12 sorry - for those two lines?

13 A Overall margins, our position is they will also remain the
14 same.

15 Q Okay. So could you summarize that for us?

16 In Premera's view is there any change as a result of the
17 conversion in premium rates in Eastern and Western
18 Washington or in total average premiums in the individual
19 and small group lines of business?

20 A Premera's position is that there will be no change to the
21 premiums in individual and small group business in Eastern
22 Washington, Western Washington or total as a result of the
23 conversion.

24 Q Now, having stated that, let me ask you this: Could you
25 explain to us what you mean when you say that rates and

1 margins will not change in those areas and those lines as a
2 result of the conversion?

3 A Well, let me make it clear that the premium rates are likely
4 to increase because of trend. And our operating margin, as
5 shown in our filed Form A financial projections, is expected
6 to increase due to administrative efficiencies, but that has
7 nothing to do with the conversion. That's expected either
8 way.

9 Q Now, if you were to draw a sketch on those premium rate
10 issues that we have been talking about, by way of making an
11 up arrow for increase, down arrow for decrease or a line for
12 no change whatsoever, what marks would you make?

13 A I would show a mark that shows no change for premiums as
14 well as margins in Eastern Washington, Western Washington
15 and overall.

16 Q Okay. Now, have you read the PricewaterhouseCoopers report
17 entitled "Economic Impact Analysis" from October of 2003 as
18 well as their supplemental report in February of 2003 (sic)?

19 A Yes, I have read both of them.

20 Q Okay. I will just call them the PwC reports.

21 What do the PwC reports argue could happen to premium
22 rates in Eastern Washington for the individual and small
23 group line as a result of the conversion?

24 A PwC argues in their report that it is possible that the
25 premium rates in Eastern Washington for the individual and

1 small group business would increase as a result of the
2 conversion.

3 Q And what, if anything, do the PwC reports argue could happen
4 to the premium rates in the individual and small group lines
5 in Western Washington as a result of the conversion?

6 A The PwC reports suggest that the premium rates in Western
7 Washington for individual and small group would likely
8 remain the same as a result of the conversion.

9 Q What do the PwC reports argue could happen to total average
10 premium rates in those two lines as a result of the
11 conversion?

12 A PwC argues that the premium rates could increase for the
13 overall for individual and small group as a result of the
14 conversion.

15 Q Okay. Now, let me turn to what the PwC reports argue would
16 happen in Eastern Washington as a result of the conversion
17 to the margins for the individual and small group lines or
18 whatever the margins might otherwise be if there was no
19 conversion.

20 A The PwC reports suggest that the margins in Eastern
21 Washington in individual and small group would - could
22 increase as a result of the conversion.

23 Q Okay. And turning to Western Washington, as a result of the
24 conversion, what does PwC say could happen to the margins in
25 Western Washington for those lines over whatever those

1 margins might otherwise be without the conversion?

2 A PwC suggests that in Western Washington in those two lines,
3 individual and small group, would likely remain the same as
4 a result of the conversion.

5 Q What about for overall average margins for those two lines?
6 As a result of the conversion what does PwC say could
7 happen?

8 A PwC suggests that the total margin overall in - in the
9 individual and small group lines would likely - or could
10 increase as a result of the conversion.

11 Q Do you agree with the PwC arguments we have described, and
12 if not, why don't you agree?

13 A I do not agree with that and the reason I do not is because
14 it violates the principles of community rating and revenue
15 neutrality, which are required in the regulations of
16 individual and small group in the State of Washington.

17 Q Well, if you were drawing a sketch about PwC's arguments
18 regarding premium rate by way of an up arrow for an
19 increase, down arrow for a decrease or a line for no change,
20 what marks would you make?

21 A Under the premium rates in Eastern Washington I would draw
22 an up arrow to show an increase. In Western Washington I
23 would draw a mark that suggests no change. And overall I
24 would draw an up arrow, which suggests an increase.

25 Q And if you were to draw a sketch about their arguments on

1 the margins for those lines as a result of the conversion,
2 what marks would you make?

3 A I would make the same marks for the margins in Eastern
4 Washington. I would draw an up arrow showing an increase
5 for Western Washington in the margins. I would draw a
6 straight across mark showing no change. And for overall in
7 the margins, I would show an increase in the overall
8 margins, an up arrow.

9 Q Would it assist you in explaining your testimony - assist
10 all of us trying to keep all those arrows and so forth
11 straight - if you were to draw a sketch and make marks of
12 the premiums and margins under both Premera's view and PwC's
13 view that you were talking about?

14 A Yes, I believe it would be helpful. I have tried to explain
15 it in words, but it is always better to see it in a picture.

16 MR. KELLY: Commissioner, in the course of preparing
17 Ms. Halvorson for her testimony it became clear to us, as I
18 us suspect it is now clear to you, that a quick sketch of
19 the premium rates and margins that are being argued under
20 these two different views would be very helpful.

21 I would ask that the witness be permitted to use the
22 Elmo here to make those sketches for us.

23 JUDGE FINKLE: Go ahead.

24 MR. KELLY: You can step down. I think you may have
25 to turn on your mic.

1 THE WITNESS: Can you hear me?

2 A Okay. We have two different categories. We have Premera
3 and we have PwC and then we have Eastern Washington, Western
4 Washington, total and rates and margins, so I will draw that
5 first.

6 MR. KELLY: Move the sketch over a bit so we can
7 see.

8 THE WITNESS: I need to take another art class.

9 A So Premera - Premera's position is that the marg- - the
10 premium rates in Eastern Washington, Western Washington and
11 in total will remain the same as a result of the conversion,
12 so I will just draw that first.

13 And Premera also - our position is that the margins will
14 remain the same in Eastern Washington, Western Washington
15 and total for the individual and small group lines of
16 business as a result of the conversion.

17 PricewaterhouseCoopers argues that the premium rates in
18 Eastern Washington for individual and small group will
19 increase - could increase and that the premium rates in
20 Western Washington in individual and small group are likely
21 to remain the same and that the total overall premium rates
22 for the individual and small group business could increase.

23 And following the rates, also PwC argues that the
24 Eastern Washington margins for individual and small group
25 business could also increase as a result of the conversion.

1 They suggest - PwC suggests that the Western Washington
2 margins for individual and small group would likely remain
3 the same, and thus the total margins overall for individual
4 and small group business could increase.

5 Q Okay.

6 A There is the picture.

7 Q Okay. If you could have a seat again, we will . . .

8 Now, when you were standing up at the Elmo, you talked
9 about Western Washington rates and margins and - as
10 remaining the same. What is your view as to what the
11 context for that is?

12 A The context is that as a result of the conversion that the
13 rates and the margins would stay the same. As I mentioned
14 before, premium rates are likely to increase with trend in
15 the healthcare costs and our margins are expected to
16 increase somewhat due to our efficiency and our
17 administrative expenses, the work we are doing around that.
18 But otherwise, before or after conversion, with or without
19 conversion, they should be the same.

20 Q All right. So they won't change as a result of the
21 conversion; is that what you are telling me?

22 A No.

23 Q Okay. I would like to turn to another area for a moment and
24 that is the prefiled testimony of Ms. Lichiou Lee.

25 Have you reviewed her direct and responsive testimonies?

1 A Yes, I have.

2 Q Do you generally agree with the statements that she makes in
3 her prefiled testimony?

4 A Except for a few comments and explanations I would like to
5 make today in my testimony, I do generally agree with her
6 testimony.

7 Q Let's take a look first, if we could, at Hearing Exhibit
8 S-51. And if you have a copy of that up there in front of
9 you, that would be good. And that is Ms. Lee's prefiled
10 direct testimony.

11 MR. KELLY: Okay. Does everyone have a copy in
12 front of them there? I am going to ask you to go through
13 these paragraph by paragraph.

14 JUDGE FINKLE: We actually have only the first page.

15 MR. KELLY: Oh. We have a . . .

16 JUDGE FINKLE: We have got it now --

17 MR. KELLY: Oh, you do?

18 JUDGE FINKLE: -- but the book didn't contain it.

19 MR. HAMJE: For clarification purposes, if you may
20 recall at the time that we filed these, since these had
21 already been filed with bench copies previously, we had only
22 included for this second filing just a copy of the first
23 page of all these documents. So you should have a
24 sufficient number of copies, it just may be that they are in
25 a different location.

1 JUDGE FINKLE: Thanks. We have got it anyway. Go
2 ahead.

3 MR. KELLY: Because I'm going to be going through
4 it. Ms. Sureau, do you have one as well?

5 MS. SUREAU: We don't have one at the moment,
6 Mr. Kelly.

7 MR. KELLY: I think we maybe have a clean one. I
8 think it is worth it, if we could just take a moment.

9 JUDGE FINKLE: Sure.

10 MS. BEUSCH: We have one.

11 MS. SUREAU: We do have one. Thank you.

12 MR. KELLY: You do? Okay.

13 Q (BY MR. KELLY) Okay. Well, I do plan on asking you about
14 those paragraphs. The first five are pretty easy. They
15 discuss Ms. Lee's personal background. I take it you have
16 no comment on those paragraphs?

17 A The only comment I have is that in all of our dealings with
18 Ms. Lee, she has been extremely professional both with me as
19 well as with the entire Premera staff.

20 Q Okay. So let's turn now to Page 2, Paragraph 6, and that
21 paragraph discusses what is called "adjusted community
22 rating."

23 Do you agree with that Ms. Lee has to say about - in
24 that paragraph?

25 A Yes, I do.

1 Q Okay. Now, Paragraph 7 discusses rating factors and the
2 principle of revenue neutrality. Do you agree with the
3 contents of that paragraph?

4 A Yes, I do.

5 Q Let me ask you, do you specifically agree with the last
6 sentence of Paragraph 7 which for the record states quote
7 "However, before and after applying any factors, the
8 projected premium must be revenue neutral, that is under
9 current demographic assumptions carriers do not gain or lose
10 the overall projected revenues before or after they apply
11 the factors," end quote.

12 Do you agree with that?

13 A Yes, I do. That is the requirement in the individual and
14 small group regulations in the State of Washington.

15 Q Okay. Now, let me turn your attention to Paragraphs 8, 9
16 and 10. Do you agree with the contents of those paragraphs?

17 A Yes, I do.

18 Q Okay. Let me turn your attention now to Paragraph 11, which
19 is on the bottom of Page 4. Do you agree with what is said
20 in that paragraph?

21 A I do. I would also like to just comment on the word
22 "cross-subsidize" here. What is meant here for
23 cross-subsidize is essentially the nature of insurance.
24 Insurance is a subsidy for all the members who purchase
25 insurance. Those who - who need healthcare, for example,

1 are subsidized by those who do not need the healthcare
2 services during the period of time. And that is what is
3 meant here by cross-subsidy. And it is related to the small
4 group business here and the individual lines of business.

5 Q So you agree with cross-subsidy, you just wanted to explain
6 that that is not something that's --

7 A No, that is the nature of insurance and, yes, I do agree.

8 Q Okay. And now, if you turn to Page 5, Paragraphs 12, 13 and
9 14, do you agree with those?

10 A Yes, I do.

11 Q Okay. Let's turn to Page 6, Paragraph 15, do you agree with
12 what is said in Paragraph 15?

13 A I do, although I would like to add some additional comments
14 related to competitiveness and area factors.

15 Q Okay. Well, what points do you think should also be made
16 when one is discussing what is said in Paragraph 15?

17 A Well, Ms. Lee states here that in her opinion there are ways
18 that Premera may be able to increase its competitiveness in
19 certain regions by setting the area factors. And what I
20 would like to add is I believe that is true. I agree with
21 her, however if you are going to be increasing
22 competitiveness in certain areas because of the revenue
23 neutrality requirement, you will be decreasing
24 competitiveness in other areas.

25 Q Okay. And the final paragraph in Exhibit S-51 is Paragraph

1 16. What do you have to say about that paragraph?

2 A I also generally agree with the example that Ms. Lee is
3 describing here, however I think it is only part of the
4 story.

5 Q Okay. What does she say in Paragraph 16 in summary?

6 A She talks about a way to increase margins in particular
7 areas in individual and small group by changing
8 reimbursement levels to providers, but not updating the area
9 factors.

10 Q And what does she infer from such a hypothetical situation?

11 A She infers that - or at least if - if you read it only with
12 that part of the story - I'm not sure if she is inferring it
13 or not - but with only part of the story it suggests
14 possibly that total margins would increase in those lines
15 where you do this, but because of the revenue neutrality and
16 the requirements to - that the revenue be the same before
17 and after change - applying factors, that would mean that
18 the margins would have to decrease in the other areas so -
19 because the premium would be the same unless the margins
20 would be the same overall.

21 Q So one half of the story is margins could increase in
22 certain areas, but the other half of the story is what?

23 A Margins would decrease in the other areas.

24 Q And what would the overall impact be for all regions total?

25 A For all regions, the overall impact would be no change, both

1 in premium as well as in margin.

2 Q Okay. Now, let's turn to Ms. Lee's prefiled responsive
3 testimony, which is Hearing Exhibit P- - I'm sorry - S-52.
4 I know you have a copy. I hope the Commissioner does.

5 MR. KELLY: And we have a spare clean copy if anyone
6 needs it.

7 This is a spare one. Do you have it?

8 MS. SUREAU: Thanks, Tom.

9 MR. KELLY: Okay.

10 Q (BY MR. KELLY) Okay. Well, let's take a look at S-52. The
11 first paragraph just identifies who Ms. Lee is. What do you
12 have to say about the remaining paragraphs in S-52? That
13 would be Paragraphs 2, 3 and 4.

14 A Well, I do not believe that Ms. Lee and I have a fundamental
15 disagreement. I think we may disagree on the methods that
16 the Insurance Commissioner could use to - to deal with
17 matters of noncompliance, but ultimately I believe that the
18 result is the same.

19 Q Okay. Well, could you explain what the - what you mean when
20 you say you have different views about how the Commissioner
21 could go about regulating that?

22 A My testimony says that for individual business, the
23 Insurance Commissioner can disapprove rates and as Ms. Lee
24 points out in Paragraph 2, "The RCWs state that the
25 Commissioner may not disapprove or otherwise impede the

1 implementation of the filed rates." This is related to
2 individual business in the State of Washington.

3 However, in Paragraph 4, Ms. Lee also points out that
4 the Insurance Commissioner has general enforcement
5 authority. And I do believe that the Commissioner, if he
6 found a health plan was noncompliant on their individual
7 rating, that he would use his general enforcement authority
8 to make sure that that was changed to compliance. Which I
9 suggested that that is the ultimately the same result as a
10 disapproval, however, I do point out that I did say the
11 Commissioner can disapprove the rates and I am corrected on
12 that statement, however ultimately I believe you get the
13 same result.

14 Q Okay. Good.

15 Now, let's turn back again to the PwC proposal about
16 raising premium rates in Eastern Washington in those
17 individual and small lines of - group lines of business as a
18 result of the conversion.

19 Do the principles of community rating and revenue
20 neutrality that Ms. Lee discussed in her prefiled testimony
21 support PwC's proposal?

22 A They do not. On the contrary, PricewaterhouseCoopers'
23 arguments are violating the principles of community rating
24 and revenue neutrality that are required by the laws of the
25 State of Washington for individual and small group.

1 Q Now, is it - okay. Why don't we come on down to the board,
2 if you would, to the Elmo, to just illustrate why you
3 conclude that the principles of community rating and revenue
4 neutrality mean that PwC's proposal can't work?

5 MR. KELLY: May the witness step down to the Elmo?

6 JUDGE FINKLE: I'm sorry. Yes.

7 A Because of the requirements of revenue neutrality and
8 community rating in small group and individual lines of
9 business, if the rates in Eastern Washington were to go up,
10 as noted here under the PwC example, because of revenue
11 neutrality, the ultimate total premium should be revenue
12 neutral, which is a dash. So that would suggest no change
13 and, thus, the resulting premium rates in Western Washington
14 would necessarily need to go down.

15 Q (BY MR. KELLY) So stop you there for a minute. You agree
16 that it is possible that there could be an increase in rates
17 in Eastern Washington?

18 A It is possible that the rates could increase in Eastern
19 Washington. I believe they could if we changed the relative
20 reimbursement levels to providers in the State of
21 Washington.

22 Q But what has to happen if that occurs in Eastern Washington?

23 A As a result of the revenue neutrality, then you would have
24 to balance it so that the total revenue before or after
25 applying the factors would come out the same.

1 And so if your premium rates would increase in Eastern
2 Washington relative to Western Washington providers, for
3 example, on reimbursement rates, the Western Washington
4 rates would have to go down in order to have revenue
5 neutrality at the end of the day.

6 Q And what would happen if that were to occur, increase rates
7 in Eastern Washington, Western Washington down, neutrality
8 in rates, as a result of the conversion in terms of margins?

9 A Well, it wouldn't be because of the conversion, it would be
10 because our relative cost change. And assuming the we
11 continue to do the same thing that we do now, the margins
12 would remain the same in Eastern Washington, the margins
13 would stay the same in Western Washington and the margins
14 would stay the same overall.

15 Q Very good.

16 Okay. Does that illustrate the points that you were
17 trying to make?

18 A I believe it does.

19 Q Okay. You can have a seat again.

20 MR. KELLY: Excuse me.

21 Q (BY MR. KELLY) Now that you are seated maybe we should just
22 summarize one more time what the differences are between
23 what PwC is saying - they argue could happen - and what you
24 and Ms. Lee through the principles of community rating and
25 revenue neutrality conclude could happen?

1 A PricewaterhouseCoopers suggests that we can increase premium
2 rates in individual and small group in Eastern Washington in
3 general higher than trend leaving the Western Washington
4 rates and margins the same thus increasing both rates and
5 margins overall in individual and small group as a result of
6 the conversion.

7 We do not believe that. We believe that - it is our
8 position that premium rates, as well as the margins, in
9 Eastern Washington, Western Washington and in total will
10 stay the same either before or after conversion.

11 Q You say stay the same, not increase as a result of the
12 conversion?

13 A As a result. Yes, they would not increase as a result of
14 the conversion. As I stated before, they are likely to
15 increase, but that's due to trend and has nothing to do with
16 conversion.

17 Q And margins could increase through what mechanisms?

18 A Through our administrative expense efficiency efforts we are
19 making right now.

20 MR. KELLY: Okay. That's all I have. Thank you
21 very much.

CROSS-EXAMINATION

BY MR. HAMJE:

Q Good morning, Ms. Halvorson.

A Good morning, Mr. Hamje.

Q I had a couple of questions for you. First, I want - I wanted to make sure I understood your testimony at the very beginning of the questions that were posed to you by Mr. Kelly concerning whether rates are going to change as a result of the conversion.

And if I understand your testimony correctly, you have indicated there will be no change, is that correct --

MR. KELLY: Objection.

Q (BY MR. HAMJE) -- as a result of the conversion?

MR. KELLY: Oh, go ahead.

A As a result of the conversion, I think my testimony is that we believe the rates, as well as the margins, in Eastern Washington, Western Washington and in total for individual and small group are not going to be changing.

Q (BY MR. HAMJE) And so I want to concentrate on just the rates for the time being.

A Okay.

Q And so my understanding is as a result of the conversion, it is your - Premera's position that rates will not increase; is that correct?

1 A They will not increase as a result of the conversion in the
2 individual and small group, yes.

3 Q And when we are talking about increase, we are talking about
4 over the healthcare trend; is that correct?

5 A That is correct.

6 Q What about - will they be reduced as a result of conversion?

7 A It is not expected that they would be reduced as a result of
8 the conversion.

9 Q Okay. And then I would like to go ahead and touch for a
10 minute or two on - I guess it is Ms. Lee's testimony, her
11 prefiled responsive, S - I believe it is 52.

12 If you could refer to Page 2 of that. I believe you
13 have it in the booklet in front of you.

14 A Yes, I do.

15 Q And specifically in connection with Paragraph 4 - your
16 testimony concerning your comments about Paragraph 4, I
17 wanted to make sure, are you suggesting that the
18 Commissioner may order a healthcare service contractor to
19 change its filed individual contract rates?

20 A I'm suggesting that there are options available to him to
21 get a health insurance company who is out of compliance with
22 the regulations to come into compliance with the
23 regulations.

24 Q Well, and I understand that, but - but are you - you are not
25 suggesting, then, that he has the authority to order a

1 healthcare service contractor to change its filed individual
2 rates; is that right?

3 A I am not a lawyer. I don't know if that would be - fall
4 under his general enforcement authority.

5 Q So your answer is you don't know?

6 A I do not know.

7 Q Okay. Ms. Halvorson, in your prefiled direct testimony,
8 which is Exhibit P-82, and in your testimony, you have
9 indicated that you are responsible for three actuarial units
10 within Premera; that is the corporate actuarial, the MBS
11 actuarial and the RND actuarial; is that correct?

12 A That is correct.

13 Q Which of these units is primarily responsible for developing
14 premium rates?

15 A The MBS actuarial unit is responsible primarily for setting
16 premium rates.

17 Q Is that unit also primarily responsible for rate filings?

18 A Yes.

19 Q And your responsibilities include the development of premium
20 rates; is that correct?

21 A That is correct.

22 Q But that doesn't mean that you ordinarily do the detail work
23 regarding premium rate development; is that right?

24 A That is correct, however our pre-release peer review
25 requirements have identified rate filings as a 2A risk

1 level, which requires an officer to review the rates. So I
2 have reviewed all the rate filings with the State of
3 Washington that have gone out of our shop since I joined the
4 company in July of 2000.

5 Q You also manage the person who supervises the Premera staff
6 actuaries and other staff who actually develop the rates and
7 prepare the rate filings; is that correct?

8 A That is correct.

9 Q You also have responsibilities for overseeing the activities
10 of units that do not involve actuarial services; is that
11 correct?

12 A That is correct.

13 Q Specifically, the financial planning and analysis department
14 and the business information services unit; is that right?

15 A The business information services is our data mining and
16 data warehousing business side development area. The
17 financial planning and analysis area does quite a lot of
18 work with actuarial and that's why we moved it under
19 actuarial starting January 1st, 2003. And so I would -
20 those really do a lot of similar actuarial work, the other
21 one does not.

22 Q And you would agree that an actuary involved in rate filing
23 on behalf of a carrier must be familiar with the relevant
24 law; is that correct?

25 A That is correct.

1 Q Are you aware of the Office of Insurance Commissioner
2 disapproving any individual contract rates filed on behalf
3 of a healthcare service contractor including Premera since
4 2000?

5 A I am not.

6 Q Are you aware of the Office of Insurance Commissioner
7 requiring a healthcare service contractor to change its
8 filed rate for any individual contracts since 2000?

9 A I am not.

10 Q In your prefiled direct testimony, again, which is P-82, at
11 Page 5, you state - I will let you get there.

12 A Okay.

13 Q You state that "The effective period for rates is typically
14 12 months;" is that correct?

15 A That is correct.

16 Q Is this effective period required by state law?

17 A It is not.

18 Q Doesn't state law require that rates for contracts be filed
19 at least every 18 months?

20 A The law - I think we are getting a little confused between
21 effective period and the requirements in the state. The
22 state does require that we file premium rates every 12 to 18
23 months. That's the period of time of which we can file the
24 rates for individual and small group, however I don't know -
25 I don't believe that there is any language in the

1 regulations that state that the premium rates need to be
2 effective for 15 months.

3 For example, a group has a renewal date in February,
4 the - the premium rates are effective for them for one year,
5 typically 12 months, and then if we do not file a new set of
6 premium rates with the state because we have 18 months,
7 there is an automatic trend built in and that trend
8 continues. And so they have a new premium rate effective
9 for another 12 months, so there is a difference between -
10 and I'm not sure what you are getting at between the rate
11 filing requirements and the effective period for particular
12 individuals or groups.

13 Q Is it true that - or would it be fair to characterize that
14 Premera - Premera's policy is to - to file - make rate
15 filings every 12 months for those particular product -
16 individual or small group contracts?

17 A We really try hard to do it every 12 months, but sometimes
18 we have particular reasons, whether it is problems with data
19 or - or other particulars reasons with respect to sales and
20 marketing wanting to change the period - the date that we
21 file it and sometimes with working through some of the
22 issues with the OIC, that we actually had a little bit
23 longer than a 12-month period.

24 Q And what I'm trying to understand about your testimony is -
25 is you are drawing a distinction between the effective

1 period and the requirements with respect to how often a
2 filing should be made with respect to a particular contract;
3 is that correct?

4 A That is correct.

5 Q And do you - are you agreeing, then, that the period of time
6 for filing a contract is different than for an effective
7 period under - under Premera's policy?

8 A Under it - yes, under our policy, under our typical rate
9 filing, yes. They can be different. They can also be the
10 same if we file every 12 months.

11 Q And are you stating that the legal - or the requirement
12 under the - under the law is that the rates be filed for a
13 particular product every 12 to 18 months?

14 A Yes, I am.

15 Q I would like to go ahead and ask you to take a look at
16 Regulation 284-43-920. Are you familiar with that
17 regulation off the top of your head?

18 A Could you show me it, please?

19 Q I will.

20 Ms. Halvorson, I would like to go ahead and just direct
21 your attention to section - or Subsection 1B of that
22 regulation and if I - if you would permit me to read it, it
23 is "Every contract formed and any modification thereof and
24 every rate schedule and any change thereof shall be filed
25 with the Commissioner."

1 And then Subsection B says, "Within 30 days after the
2 end of a 18-month period during which a previous filing has
3 remained unchanged for such period including contract forms
4 filed prior to the effective date of this regulation."

5 Did I read that accurately?

6 A Yes, you did.

7 Q Does that clarify matters with respect to when the law
8 requires that the contract forms be filed - I'm sorry - the
9 contract rates be filed?

10 A Is there - can you ask me the question that was trying to be
11 clarified, please?

12 Q Oh, I'm sorry. I had understood that you said it could be
13 filed - that it was required to file it in 12 - between 12 -
14 12 and 18 months. It really is only 18 months; is that
15 right?

16 A I don't know if this clarifies it by itself. My
17 understanding is that we are allowed - and maybe I used the
18 wrong word and I apologize for that - but we are allowed to
19 file rates every - after 12 months up to 18 months and that
20 we have to do it by the end of the 18th month. That is my
21 understanding.

22 Q Thank you.

23 Now, if we can go back again to P-82, your direct
24 testimony. If you would look at Page 12, please.

25 A (Complying.)

1 MR. KELLY: What lines are you interested in?

2 Q (BY MR. HAMJE) I was - Ms. Halvorson, I was going to ask
3 you to take a look at - it looks like the question begins
4 between Lines 3 and 4 and your answer follows immediately
5 thereafter.

6 MR. KELLY: Okay. If we could let the witness have
7 an opportunity to read the question and answer and then let
8 us know when she is finished reading.

9 MR. HAMJE: Thank you, Mr. Kelly.

10 JUDGE FINKLE: Go ahead.

11 A I have read it.

12 Q (BY MR. HAMJE) Ms. Halvorson, there you note your
13 disagreement with a statement attributed to Dr. Leffler,
14 that "geographic factors by network reflect the provider
15 reimbursement level differences by area;" is that right?

16 A I'm sorry. Could you say that again, please?

17 Q Yes. You note your disagreement with a statement attributed
18 to Dr. Leffler that "geographic factors by network reflect
19 the provider reimbursement levels - level differences by
20 area."

21 A That is correct. I do disagree with him.

22 Q And you state that "the network - or geographic factors
23 reflect the estimated cost of care not just provider
24 reimbursement levels;" is that correct?

25 A That is correct.

1 Q And you state further that "Premera's geographic area
2 factors are based on three things: One, expected
3 differences in unit costs for hospital and professional
4 services within a defined area;" is that right?

5 A That is correct.

6 Q Is that essentially the same thing as provider reimbursement
7 levels?

8 A Yes, it is.

9 Q And then, two, you add another factor you say, "efficiencies
10 of the various networks by area;" is that correct?

11 A That is correct.

12 Q And then you also add a third one, "adjusted for the pattern
13 of where policyholders living within the area are expected
14 to receive care;" is that correct?

15 A That is correct.

16 Q Those factors are weighted in connection with their use in
17 rate development; is that correct?

18 A Yes, they are.

19 Q Would it be fair to state that greatest weight is given to
20 the first component, that is "expected differences in unit
21 cost for hospital and professional services within a defined
22 area"?

23 A That typically would be the case, but, again, it depends on
24 the area. The idea here is that Premera has a statewide
25 provider network and people can go anywhere within the

1 networks purchased to get their care. If they live in
2 Spokane, they can come to Seattle to get care. And that's
3 what we are trying to reflect here.

4 And there may be particular areas where there is more of
5 a 50/50 split. They may go, for example, to the east side
6 versus Spokane - versus Seattle metro. That's more of a
7 50/50 kind of a split. So it depends on the area as well as
8 the choice of the member.

9 Q But don't most people go to their providers that are nearby
10 rather than go from one end of the state to another to a
11 provider?

12 MR. KELLY: Well, I'll --

13 A Well --

14 MR. KELLY: Sorry.

15 A -- what do you mean by "nearby"?

16 Q (BY MR. HAMJE) Well, someone located in Spokane not
17 ordinarily going to see a primary care physician in Seattle;
18 is that correct?

19 A That's possible, but they may very well to come to Seattle
20 to get cancer care or transplant care or to some other
21 center of excellence where they don't - maybe won't have
22 that in Spokane. And maybe their family is here and it's a
23 long, extended stay, so they also choose to come to Seattle
24 from Spokane.

25 Q But if I recall, your answer originally was that typically

1 the factor that is given the greatest weight is the factor
2 involving expected differences in unit costs for hospital
3 and professional services within a defined area; is that
4 right?

5 A Typically, yes.

6 Q And can you estimate the weight given typically given as a
7 percentage?

8 A It varies by area and I don't have that information in front
9 of me.

10 Q Also in your - in your prefiled direct testimony at Page 6 -
11 and this is the paragraph beginning at Line 8, if you would
12 just read that paragraph, please, to yourself.

13 A (Complying.)

14 I have read it.

15 Q You state that "The geographic area adjustments are based
16 upon expected costs for members in that particular area, not
17 on the expected payments to the providers;" is that right?

18 A I do say that, however the sentence by itself needs to be
19 taken in context with the sentence before and the sentence
20 after.

21 Q Certainly, I understand that.

22 Are expected payments to the providers included in the
23 cost model?

24 A Yes, they are.

25 Q And are payments made to the providers included in the cost

1 model?

2 A The reimbursement levels are included in the cost model,
3 which is essentially the unit cost of a service to be
4 provided. Utilization levels are also included in the cost
5 model, which estimate the number of services provided on
6 average for a population by service category.

7 So you multiply the two, you get the total expected
8 cost, so the payments themselves by - for a particular
9 provider aren't necessarily identifiable in the cost model,
10 however the average reimbursement rate for services by a
11 service category - and there is about 50 service categories
12 in the unit cost - in the cost model - as well as assumption
13 to the utilization of services are both included in the cost
14 model.

15 Q I wanted to also just ask you a few questions about revenue
16 neutrality. Are you suggesting that all other things being
17 equal, the use of actuarial judgment could never result in
18 rates, say, for small group contracts increasing in Eastern
19 Washington more than they would decrease in Western
20 Washington?

21 A I don't think I said that.

22 Q I'm not - I'm not suggesting that you are saying it. I'm
23 asking whether your testimony - in your testimony you are
24 suggesting that could happen or not?

25 A I can give you an example where that could happen as long as

1 the revenue neutrality requirements remain the same so
2 that - are still in place so total overall revenue remains
3 the same. Revenue from Eastern Washington could increase
4 more than the revenue could decrease in Western Washington,
5 for example, if there was appropriate reasons why, if we had
6 three-quarters of the population in Western Washington in
7 that line of business and only one-quarter in Eastern
8 Washington, so it is - it is a law of averages.

9 Q So I want to make sure that therefore you would - you do not
10 believe that actuarial judgment alone could result in
11 increase in Western - I'm sorry - in Eastern Washington in
12 excess of a decrease in Western Washington; is that correct?

13 A That is correct.

14 Q Would you agree that the revenue neutral requirement applies
15 to rate filings related to previously introduced products
16 for which there is credible experience?

17 A I would agree with that.

18 Q But what about a new product that is similar to a previously
19 introduced product but differs in small but material ways in
20 terms of benefit design and network efficiencies, would the
21 revenue neutrality requirement apply to it as well?

22 A You would build it into the calculation of revenue
23 neutrality, but however since there is no demographics
24 included with that product, nobody has bought it yet, the
25 weight is zero.

1 MR. HAMJE: Thank you. That's all the questions I
2 have.

3 MS. HAMBURGER: We have no questions.

4 MS. McCULLOUGH: I have just a couple.

5

6 CROSS-EXAMINATION

7

8 BY MS. McCULLOUGH:

9 Q Hi, Ms. Halvorson. I'm Amy McCullough. I'm here on behalf
10 of the Alaska Intervenors.

11 A Hello.

12 Q To your knowledge, Premera is subject to premium taxes in
13 both Washington and Alaska; is that correct?

14 A It is with some minor differences.

15 Q Okay. And those premium taxes are factored into Premera's
16 rate filings; is that correct?

17 A Yes, they are.

18 MS. McCULLOUGH: Thank you. No further questions.

19 MR. KELLY: Okay. Redirect.

20

21

22

23

24

25

REDIRECT EXAMINATION

BY MR. KELLY:

Q When you were discussing geographic factors with Mr. Hamje, you said that revenue could increase more in Eastern Washington than in Western Washington. Were you talking about premium rates or revenue?

A Premium rates.

Q And, finally, as a perfection- - as a perfectionist and as a professional actuary, would you approve a rate filing that violates Washington law including the revenue neutrality and community rating regulations?

A You are asking my opinion as an actuary?

Q Yeah. What would you do as an actuary? Would you ever violate - would you ever approve or submit a rate filing that violates Washington law?

A I would not knowingly do that.

MR. KELLY: Excuse me.

That's all we have.

MR. HAMJE: No further questions.

EXAMINATION

BY COMMISSIONER KREIDLER:

Q Ms. Halvorson, I was just curious on the particular point that - in your choice of words, that you frequently use the term "Premera's position." Is that something that because of the area that you work in relative to being an actuary that policy decisions relative to rates, for example, would be outside of where you would have, so to speak, expertise or would provide the specific direction?

A As a senior management of Premera - as senior vice-president and chief actuary, I represent Premera often, but it is the - it is my responsibility and so it is also my position that at this point there are no plans to change our methodology or our process and we will continue to file rates appropriately that meet the requirements of the state.

Q So - so, in other words, that is something that - that could change depending on Premera's position?

A I do not believe so. We have - as you can guess, we often have healthy conversations with the sales folks and that - that keeps us in line. But especially with the individual and small group, we don't have - we don't have any opportunity to vary from the rates filed and so that limits their pressure on us. However, they do review our rates and we do consider the competitive nature of the market, but it

1 is our responsibility in the actuarial department to make
2 sure that we - we do the right thing.

3 Q On the question of - of revenue neutrality, you indicated
4 that there would be several - the potential here of
5 efficiencies that could be derived that would essentially
6 add to Premera's bottom line by virtue of those
7 efficiencies. Do you have any examples of what those might
8 be?

9 A I do from my department. For example, we had filed a
10 three-year administrative plan for 2004, 2005 and 2006 and
11 we had to be very careful in our expansion requests for FTEs
12 and - for example, and we were not allowed as many as I
13 would have liked.

14 And so we had particular targets that we needed to meet
15 we built those into our projects. So I can only speak to my
16 department related to that, however we are working to make
17 our services a lot more efficient. I think Mr. Smit talked
18 about a number of those things that we have done recently.

19 Q I'm curious, relative to the differences - you mentioned the
20 competitiveness of the marketplace would act as a constraint
21 to Premera in altering its position on neutrality for
22 revenue for rates. I'm curious, though, if that same
23 competition indicated that it was more competitive
24 theoretically, and - which is probably not too theoretical -
25 in Western Washington as opposed to Eastern Washington, that

1 the same competitive forces would potentially, within the
2 constraints of the law, effectively see rates not
3 improving - or not as - not as good a rates in Western
4 Washington as opposed to Eastern Washington?

5 A If I - if I understand you correctly, I think I disagree
6 with you. I don't believe that our rate setting of our
7 geographic factors have anything to do with the competition
8 in setting the geographic factors. The overall base rate
9 may be, for example, what trend rate do you use for
10 prescription drugs?

11 Again, I'm sure Mr. Hamje understands there is a lot of
12 judgment in actuarial work since we are projecting the
13 future and the future hasn't happened yet. So do you use
14 the trend rate of 19 percent or do you use a trend rate of
15 20 percent based on utilization and average charge
16 assumptions that we know of historically as well as what
17 information we can get about, for example, drugs in the
18 pipeline that are expected to hit the market, we then
19 estimate what those trends are going to be.

20 If the sales organization comes back and says, "Well
21 everybody else is doing 25 percent, not 20 percent, push it
22 up," we will say, "Well, we don't want to do that because we
23 want to be competitive."

24 On the other hand if they say, "Everybody is doing 15"
25 and you can't prove that those drugs in the pipeline are

1 going to keep it at 19 percent, we may consider adjusting it
2 because of the judgment that is involved.

3 Q Is it possible that there could be a difference, then, by
4 region so that somebody living in one region might be more
5 of a beneficiary of that competition and - and those
6 determinations from the example you just gave, than another
7 region?

8 A No, and that's due to the community rating requirements.
9 You take all of the experience - all of the small group
10 members across the state or all of the individual members
11 across the state, you pool them together, apply a trend to
12 project out what your expenses are going to be, your
13 healthcare costs are expected to be for this effective
14 period you were talking about where the insurance is going
15 to be in place, and then you apply your geographic area
16 factors. So the entire pool is applied the single trend
17 rate so everybody gets the same effect.

18 Q So you would say, then, in effect, that because of the - for
19 the reasons that you just stated that even operational
20 efficiencies that might be achieved in one region as opposed
21 to another wouldn't be reflected in the rates?

22 A They would be, because we would take the average overall
23 administrative costs, would show the - the efficiencies in
24 one area or the other, if there happens to be one, and
25 aggregate that together to a single retention load for the

1 entire block. So everybody gets the same effect of it even
2 though - even if you can apply it to a particular area.

3 Q So there would be no difference, then, even if there were
4 some subjectivity involved in making the determination as to
5 the efficiencies in one region as opposed to another as to
6 the rates that would be experienced from one region to
7 another?

8 A That is correct, again, because the community rating, you
9 only get to apply one retention load and not different ones
10 by area.

11 COMMISSIONER KREIDLER: Thank you very much.

12
13 REDIRECT EXAMINATION

14
15 BY MR. KELLY:

16 Q Now, I asked questions using the phrase "Premera's position"
17 and I think you responded that way. Are - is everything
18 that you testified to in regard to Premera's position also
19 your own personal opinion as an actuary?

20 A Yes.

21 Q Okay. And the Commissioner asked a question about whether
22 there could be any change in approach. If I could ask you
23 to put this in context, if PwC had a proposal that it
24 thought might be a way of changing rates in Eastern
25 Washington without changing them in Western Washington, is

1 that something that Premera has ever done in regard to
2 individual and small group rates?

3 A I have only been with the company since July of 2000, but
4 not to my knowledge.

5 Q Okay. And so this is something that is being proposed by
6 PwC as some sort of resolution or solution; is that correct?

7 A They propose it as something that could happen should we
8 increase the rates in Eastern Washington above trend, and
9 you just can't do that.

10 Q And why is it that you couldn't just increase it in Eastern
11 Washington?

12 A Because of the community rating requirements where you apply
13 the trend to the base rate from your experience and project
14 it forward overall. And the revenue of neutrality
15 requirements, if you decide to change the geographic
16 factors, for example, which is not really their example,
17 would require that the total overall revenue remains the
18 same.

19 Q So this proposal of PwC is something that Premera hasn't
20 done, doesn't intend to do and you think violates the law;
21 is that correct?

22 MR. HAMJE: Objection. Leading.

23 JUDGE FINKLE: Sustained.

24 Q (BY MR. KELLY) How would you describe the PwC proposal?

25 A The PwC proposal is not something that I would attempt to do

1 because it violates the principles of community ratings and
2 revenue neutrality that are required by the regulations in
3 the State of Washington for individual and small group.

4 MR. KELLY: Excuse me.

5 Q (BY MR. KELLY) I think you - the question was raised about
6 actuarial judgment. Can actuarial judgment as to a trend
7 apply in just one region or part of the state or not?

8 A For individual and small group?

9 Q Yes.

10 A No.

11 Q Yes.

12 A It cannot apply to a single area. It applies to the entire
13 state.

14 Q And that is based upon --

15 A Community rating requirements.

16 Q Which I think you described in some detail with the
17 Commissioner's question.

18 MR. KELLY: Okay. That's all I have.

19 MR. HAMJE: Thank you, Ms. Halvorson, no further
20 questions.

21 MS. McCULLOUGH: Nothing.

22 MR. KELLY: Okay. Thank you.

23 JUDGE FINKLE: Thank you. Please step down.

24 MR. KELLY: Next witness is Patrick Fahey.

25

PATRICK FAHEY,

having been first duly
sworn by the Judge,
testified as follows:

JUDGE FINKLE: Please sit down.

DIRECT EXAMINATION

BY MR. KELLY:

Q Good morning, sir. Do you want to get a class of water?

A No, I'm fine, thank you.

Q Would you state your name, title and employer and for the record give your business address?

A I'm Patrick M. Fahey. My employer is Wells Fargo & Company
and the business address is 47th Floor, 999 Third Avenue,
Seattle.

Q What is your relationship to Premera Blue Cross?

A I'm currently a director of both Premera and Premera Blue Cross, a member of the board of - excuse me - the governance committee and executive committee as well as chairman of the compensation committee.

Q And how long have you served on the board?

A I was elected to the board in October of 1998.

Q Could you summarize for us your educational background?

A I'm a graduate of Seattle University, of the Pacific Coast
Banking School and of the management program at the Graduate

1 School of Business at the University of Washington.

2 Q And then tell us about your business career.

3 A After a stint in the Army as an officer - wasn't a great
4 choice - I joined Seafirst Bank at the time in June of 1967,
5 remained there until late 1981 attaining a level of senior
6 vice-president. I then joined Old National Bank as the
7 regional manager for Western Washington in 1981 and became
8 president of Old National Bank in 1983.

9 Then I left that company to form the Pacific Northwest
10 Bank where I was the founder, chairman, president, chief
11 executive officer. That company merged with Interwest Bank
12 Corp in 1998. As - I was a member of the board of directors
13 of Interwest and vice-chairman for commercial banking
14 running the six subsidiary commercial banks of Old - of
15 Interwest.

16 In the year 2000 I was asked to take over the entire
17 company and we combined them all under the Pacific Northwest
18 Bank banner where I remained the current president and chief
19 executive officer of Pacific Northwest Bank of Portland as
20 well as its primary subsidiary to Pacific Northwest Bank.

21 Recently Pacific Northwest Bank was acquired by Wells
22 Fargo & Company and after a conversion a couple of weeks
23 ago, I became the chairman for regional banking for Wells
24 Fargo & Company, which I currently am.

25 Q Now, aside from your employer and Premera, you have been

1 act- - you are active in number of other organizations; is
2 that correct?

3 A Yeah, I think that's fair to say.

4 Q And there are quite of number of them listed in your
5 prefiled direct testimony; is that right?

6 A Yes.

7 Q That includes, by the way, serving on the board of directors
8 of Physicians Insurance and on the college advisory board of
9 the School of Business in Economics at Washington State
10 University, member of the board of trustees of Seattle
11 University and cochair of the Capital Campaign for Pathways
12 for Women; is that true?

13 A Yes, it does, along with a number of other civic and
14 business and charitable organizations over the years.

15 Q Now, your prefiled direct testimony has been served and
16 filed in this proceeding. Do you adopt that testimony?

17 A I do adopt and it affirm it.

18 Q Okay.

19 MR. KELLY: And Mr. Fahey's prefiled direct
20 testimony is Hearing Exhibit P-48 and with his adoption of
21 the testimony, Premera moves to admit that exhibit.

22 MR. HAMJE: No objection.

23 MS. HAMBURGER: No objection.

24 JUDGE FINKLE: Admitted.

25 Q (BY MR. KELLY) Can you describe for the Commissioner the

1 purpose of Premera's compensation committee?

2 A Yes. Commissioner, the purpose of the committee is to
3 ensure that Premera has a competitive and reasonable
4 compensation program that will attract and retain the most
5 talented executive management that we can find as well as
6 others throughout their organization, to ensure that all of
7 our executives and officers and employees really are
8 motivated to achieve the company's objectives and, perhaps
9 as importantly as anything to align, the efforts and
10 objectives of our management, long-term goals and objectives
11 of the company.

12 Q Okay. And are the purposes that you have described set
13 forth in the compensation committee's written chart?

14 A Yes, they are.

15 Q Now, what role does the committee have in regard to
16 Premera's compensation philosophy and in regard to
17 implementing that compensation program?

18 A Well, the committee's responsibility is to develop the
19 compensation philosophy for the company and recommend that
20 to the board of directors and then to implement the various
21 programs and plans that will achieve the objectives
22 contained in that philosophy.

23 Q Does the committee also have a role in regard to the
24 compensation of the board members?

25 A Yes, it does.

1 Q And what is that role?

2 A Well, its role is to review the pattern, practice and
3 competitive director fees and so forth that are being paid
4 for companies similarly situated throughout the - comparable
5 in revenue and complexity and to come up with a
6 recommendation based on the recommend- - on the survey as
7 well as recommendations of the outside compensation
8 consultant, recommend those fees to the board of directors.

9 Q Okay. Does the compensation committee have any professional
10 resources to assist it in its work in regard to compensation
11 both for executives and for the board itself?

12 A Yes, it does. We don't rely exclusively on the expertise
13 from the various members of the committee. We retain - and
14 when I say "we," I mean the competency committee - retains
15 an outside independent consultant to both survey the market
16 as well as to come up with suggestions, recommendations,
17 data and so forth for us to consider in our deliberations
18 and establishing both the plans for compensation as well as
19 absolute levels, particularly for chief executive officer.

20 Q What is the name of the outside compensation consultant that
21 the compensation committee is currently using?

22 A We are currently using Mercer Human Resources Consulting,
23 which is a national firm, very highly regarded, and with
24 which we have been quite satisfied in terms of our result.

25 Q Does Mercer serve at pleasure of the compensation committee?

1 A It absolutely does. Our charter states that we discuss at
2 some length which consultant we will use, the results we
3 receive from that consultant and, in fact, the negotiations
4 regarding the consultants in contract - or the engagement
5 letters as sometimes referred to - the fees involved and the
6 nature of the work and scope of the work are discussions
7 that take place between myself as chairman of the committee,
8 with the approval of the entire committee, and when the
9 outside consultant and I sign the engagement letter.

10 Q So you are free to select, retain, terminate, approve or
11 disapprove the fees of the consultant and decide which
12 consultant to use?

13 A Absolutely. Our charter says that and that is the practice
14 of how we operate.

15 Q And that decision-making and all experience components are
16 done without seeking approval of the full board or of the
17 management executives?

18 A We certainly discuss it with the board and we report to the
19 board our deliberations. And I expect, frankly, that the
20 board could rise up and object and we would certainly listen
21 to that, but it is within the purview and province of the
22 committee to do that.

23 There is no influence or - from management and nor is
24 there any discussion with management about whom we will
25 select as our consultant.

1 Q Now, as chair of the compensation committee you have
2 described some of your responsibilities. Why don't you just
3 sort of give us an overall review of your main
4 responsibilities?

5 A Well, primarily I chair the committee meetings, set the
6 agenda, deal with the consultant as the primary contact,
7 although there is nothing to prevent any other member of the
8 committee from having direct contact with our consultants.

9 And then I ensure that we are operating in accordance
10 with best practices, and - as we have adopted really quite
11 sometime ago, standards and procedures in policy that are
12 quite consistent - absolutely consistent with what later
13 followed in the Sarbanes-Oxley legislation and so forth -
14 ensuring that we are operating in accordance with the
15 appropriate rules of appropriate governance, and ultimately
16 I take the recommendations of the committee to the full
17 board for their review and present them for approval.

18 Q And Sarbanes-Oxley applies to public companies, but does not
19 apply at this time to private companies?

20 A No, Mr. Kelly, it does not apply per se. However this
21 company, I think, has very much been on the leading edge, I
22 think, of adopting best practices.

23 Shortly after I joined the board - and I believe it was
24 the second time - an individual by the name of Rom Sharone
25 (phonetic) who is regarded as an credible guru of corporate

1 governance in America, did a number of books which are the
2 textbook for governance and operating rules for a board, in
3 a retreat - a couple of retreats to look at the way our
4 board operated and suggested things that could be done.

5 And as best I can recall and I think an accurate
6 statement, we did adopt all of his best practices
7 recommendations, everything from things that should be done
8 in executive session to, you know, the method of discussion,
9 deliberation, number of meetings, length of meetings, you
10 name it.

11 So I'm really quite confident that we are operating,
12 although we are not required to, within both the spirit and
13 the letter of what is required by Sarbanes-Oxley and
14 generally by the various stock exchanges, particularly the
15 New York Stock Exchange.

16 Q Now, in addition to yourself, who are the other members of
17 the compensation committee?

18 A Well, we have - we get some varying perspectives by the
19 constitution and makeup of the committee. We have Maria
20 Pope, who is currently the vice-president and general
21 manager of the wood products division of Pope and Talbon
22 (phonetic), a forest product company where she was
23 previously also a chief financial officer.

24 We have Eleanor Andrews, who is president and chief
25 executive officer of the Andrews Group, which handles

1 facilities management maintenance and support operations in
2 Alaska for both private and public government type entities.

3 And we have John Lanen (phonetic), who is - until very
4 recently was the executive secretary-treasurer of the
5 Spokane Labor Council, the AFLCIO, and the managing editor
6 of - I believe it is called "Labor World Publications."

7 Q Generally what procedures are in place to ensure that
8 compensation committee is independent from Premera's
9 management in regard to its executive compensation?

10 A Well, by the definitions of independence as contained in
11 Sarbanes-Oxley as well as in the exchange rules and
12 regulations, the committee is independent meaning that no
13 member of the committee has a material relationship with the
14 company other than services as a director.

15 Additionally, our independence is obtained and
16 maintained by having executive sessions regarding anything
17 that pertains to, for example, the chief executive officer.
18 We frequently have the chief executive officer in attendance
19 for information that we may need or require all discussion.

20 Deliberations and actions related to anything that
21 affects the chief executive officer are done in executive
22 session. No discussion is held regarding those items before
23 or after by myself or and, to the best of my knowledge, by
24 any member of the committee nor would our chief executive
25 officer seek any discussion.

1 And we take the - well, we retain the outside consultant
2 to give us the third-party, completely independent
3 perspective and input relative to the market that we are
4 competing within to the practices, policies adopted by other
5 companies and a number of other factors that we take into
6 account.

7 Q What is the compensation committee's overall philosophy with
8 respect to executive compensation?

9 A Well, I think I sort of alluded to earlier, we - we strive
10 to establish policies as well as plans and programs that
11 will allow us to attract and retain the most talented,
12 executive management, senior management that we can. Being
13 in this competitive environment that is very much what we
14 need to have. We can't - will become mediocre if we have
15 mediocrity at the helm, certainly, so that's the primary
16 objective.

17 And as I mentioned, I think we attempt to provide a
18 program that motivates the executives and senior management
19 to work towards the objectives established by the company as
20 well as, again, to align their interests, financial and
21 personal, with the long-term best interest of the company
22 itself.

23 Q Okay. What is the committee's philosophy in regard to the
24 levels of compensation for its executives?

25 A Well, again, we want them to be competitive. And generally

1 that means that we will attempt to target the level of
2 compensation for executives at the median market based on
3 the data and survey information that we receive - median
4 level, excuse me.

5 Q Can you go up or down around the median?

6 A Well, it can for a number of reasons. It is not a
7 rubber-stamp situation. We receive a lot of data. We
8 analyze it and have a lot of discussion, get additional
9 input from the consultant and come up with generally an idea
10 and so forth.

11 And the discussion is to whether or not and an
12 individual's compensation would vary from the median, but
13 generally it revolves around whether or not the person is
14 new in the job, relatively less-experienced, perhaps, than
15 you might find at the median or even the level of
16 competence.

17 There are also situations where because no company
18 necessarily is structured exactly like another company and
19 that there are many different organizational structures and
20 so forth that could create a situation where one of our
21 executives would have duties that are beyond the scope or
22 the job description, if you will, that are those that are
23 generally covered in the survey. And we would take that
24 into account. And we have had that situation, that - and we
25 have reacted to it.

1 And then we take into account, certainly, factors such
2 as the performance of the company, the attainment of
3 objectives by an individual executive, performance overall.
4 So there are any number of factors that are considered,
5 discussed and debated and - that weigh upon the ultimate
6 base compensation level that is selected.

7 Q When you look at the peer groups, do you look at both
8 for-profit and not-for-profit health insurance companies?

9 A We do. And that is the pool, if you will, from which we
10 both attract executives, when we need to hire one, and also
11 the pool of companies that would be out there attempting to
12 proselyte our executives because we do have a very capable
13 and well-known group.

14 And so we do feel it is appropriate and our consultants
15 also strongly recommends that we use a blended pool of both
16 for-profit and not-for-profit companies. And the for-profit
17 would include public companies as well.

18 Q Okay. Let me turn your attention to a conversion issue. If
19 Premera becomes a publicly traded company, what changes, if
20 any, do you see the compensation committee needing to make
21 to its member composition, independence from Premera
22 management or its procedures?

23 A Well, I don't think there would be any requirement to make a
24 change in the composition of the committee. The committee,
25 as I have indicated, is comprised of independent directors

1 as - it is approved for us even as a not-for-profit company
2 and also required in the public world, so the compensation
3 would be similar, but different players as people rotate off
4 and so forth.

5 But we would look for varying perspectives from
6 different backgrounds and occupational areas and so forth,
7 which we currently have.

8 In terms of the procedures, Mr. Kelly, I don't really
9 think there would be anything that I can think of that we
10 are not now doing that would be required. And the
11 difference would be that we would - we would have to, for
12 example, in the proxy statement that we have - the report -
13 discuss the committee's charter, the nature of its
14 activities and the procedures and policies that its uses.
15 We would have to show some of the information that you
16 typically find in a proxy statement for a public company
17 today.

18 We would be bound by the rules of the New York stock
19 Exchange, but we believe we are already following,
20 essentially, those rules. So procedurally I don't think
21 that there is really any significant change that we would
22 make, either our procedures nor frankly in our philosophy
23 and policies.

24 Q Okay. Why do you say there would be no change in your
25 philosophy?

1 A Well, I think our philosophy is consistent with a well-run
2 company, whether it is public, private, for-profit or
3 not-for-profit, and that is to run a successful enterprise
4 by having the best talent you can - you can attract and
5 motivate to stay with the company for both its expertise as
6 a group as well as for consistency.

7 And so I believe that what we are currently doing
8 fosters that and we have no - I have never heard any
9 discussion or any thought of changing our compensation
10 philosophy.

11 Q Okay. Now, has the compensation committee developed and
12 approved an equity compensation plan that will be deployed
13 if Premera becomes a public company?

14 A Yes, it has.

15 Q And was that an ongoing process? And if you could just give
16 us a thumbnail sketch of how that happened.

17 A Well, that, of course, is typically a part of the company
18 that is public and it has a number of objectives consistent
19 with the objectives of the committee that I just described.

20 We, again, with the assistance of our outside consultant
21 and work done by them, determined that it was indeed the
22 practice in companies with which we compete and with which
23 we will compete, and set about to come up with a plan, which
24 we did.

25 And I think we actually - probably the first discussions

1 of that were sometime after the original presentations that
2 led to the development of the decision. But formally we
3 heard the recommendations, discussed it, deliberated quite a
4 bit, actually sent the outside consultants back to do some
5 additional work and came up with the general concept of a
6 plan as I recall.

7 And later after considerable discussion between the
8 companies' representatives and the Commissioner's staff, as
9 well as consultants, a number of modifications were made to
10 provide more detail, for one thing, as the Commissioner
11 decided that elements of that plan - excuse me - and the
12 compensation program would be a part of the discussion and
13 the decision related to the conversion, as I recall.

14 As late as fall of last year there were some additional
15 discussions between the representatives of the company and
16 the OIC staff as well as, I believe, its consultants upon
17 which the company - or the compensation committee then had
18 further discussion and deliberation and made some
19 modifications what we felt were responsive to the concerns
20 that were expressed.

21 Q Okay. So the final version of the compensation - postequity
22 compensation plan appears in the Amended Form A as of
23 February of 2004?

24 A It does.

25 Q To the best of your knowledge, is the executive compensation

1 plan, including the equity compensation and approved by the
2 compensation committee and the board, in keeping with best
3 practices in the industry?

4 A To the best of any knowledge, it is. And I - I have run
5 three public companies myself and kept abreast of, you know,
6 what - what the situation is there. And I believe we are,
7 indeed, consistent with best practices.

8 And I also believe that, as has been stated by the
9 additional independent consultant that was retained as our
10 expert and I believe without great contradiction by the
11 experts of the Commissioner and the Intervenors and so
12 forth, it is also regarded as conservative, appropriate and
13 reasonable for comparable companies in our - in the health
14 plan industry.

15 Q Okay. Now, are you aware of the compensation assurances
16 that are of Exhibit E-8 in Premera's Form A?

17 A Yes, I am.

18 Q One of those compensation assurances provides for a - what
19 is called a designated board member to sit in the
20 compensation committee, was one that would be - that the
21 board member would be one elected from a slate nominated by
22 the foundations.

23 What is your reaction to the addition of that designated
24 board member?

25 A Well, I - I do believe, as I stated earlier, that the

1 current compensation committee, and I think that would be
2 likely to be constituted, is in fact independent and
3 operates appropriately, however I have no objection
4 whatsoever. Particularly, I would hope it would give some
5 level of comfort to some who may have some concerns.

6 I, you know, have no objection to adding another member
7 to the committee. We need all the help we can get. And I
8 think discussion is healthy, different perspectives are
9 healthy and it is fine with me.

10 Q What would you do to assist that new board member on
11 the compensation committee?

12 A Well, the same thing I do for any other new member that
13 joins the committee. We - I have a considerable amount of
14 discussion, in - what you might call an orientation, going
15 over the philosophy that we have adopted, discussing -
16 getting that person's viewpoint as well and the procedures,
17 policies that we use, discussing the outside consultant,
18 going over some of the past information, giving that person
19 copies of information that we have used, allow them to
20 review the minutes, for example, and I think probably what
21 you would expect in the orientation of any new board member
22 or committee member so that they can get up to speed
23 quickly. And - and I have seen that work well the way they
24 have done it in the past.

25 Q All right. You have mentioned several times the New York

1 Stock Exchange rules. Are you referring to New York Stock
2 Exchange Corporate Governance Rules?

3 A Yes.

4 Q And are there any provisions in those rules that relate to
5 the composition and duties of any compensation committee of
6 a company that is traded on that stock exchange?

7 A Yes, there is.

8 Q Could you just enumerate some of those? I know they are in
9 writing in the plan.

10 A Well, they are in general - first of all, they do require
11 that the compensation committee be comprised entirely of
12 outside directors on the distinctions that I previously
13 stated.

14 They require that the committee develop and adopt a
15 charter, which states the purposes and objectives and
16 philos- - not philosophy necessarily, but also the
17 procedures and so forth to be adopted.

18 It requires the use of an outside consultant. I believe
19 it - I'm not sure that it requires - I think it does require
20 executive sessions. If it doesn't, it should.

21 Q Okay.

22 A And I may be leaving something out, but in general it is the
23 things that I have discussed that are really, I believe, to
24 implement the spirit and intent of the Sarbanes-Oxley
25 legislation.

1 Q What does it say about who determines and approves the CEO's
2 compensation?

3 A Oh, it requires the committee to establish the CEO's
4 compensation. And, again, I'm not recalling specifically
5 that it requires it, but in fact it at least must recommend
6 it. And we also certainly establish the parameters and
7 ranges for the senior executives in the company as well.

8 Q Okay. Another - going back to the compensation assurances
9 in the Amended Form A, another one has a provision regarding
10 the peer group that the compensation committee will be
11 using.

12 What do you think of that peer group?

13 A I have no problem with that.

14 Q Okay. And the assurances will be in place for a two-year
15 period. What is your reaction to that two-year period?

16 A Well, my honest reaction would be that I'm not sure that
17 such a restrictions is necessary, you know, to sort of
18 control or influence the deliberations of the committee, but
19 again, I don't have any objection to it.

20 I do think that it would be unwise and perhaps even
21 harmful to have an overly extended period of restrictions
22 because I believe, as our previous witness indicated, you
23 know, the future hasn't happened yet and we don't know what
24 changes in approach and the competitive marketplace might
25 occur. To bind the hands of the committee would possibly

1 prevent us from having what we are seeking to achieve by -
2 by the objectives and philosophy that I mentioned earlier.

3 And, additionally, I might add that in terms of checks
4 and balances, if you will, and controls and restraints upon
5 a public board or a public company board or a compensation
6 committee, you ain't seen nothing like the suasion that
7 occurs from shareholders, from regulators who have reviewed
8 that sort of thing, a number of organizations.

9 For example, were we to run amok, so to speak, we would
10 be subject to a great deal of input, pressure and probably a
11 need to change from shareholders, from the public at large.
12 There are many groups watching public companies. There is a
13 group, for example, Mutual Shareholder Services, which
14 reviews in great deal the proxy of every public company that
15 is issued prior to its annual shareholders meeting and
16 offers its opinion of the practices, the compensation
17 program and so forth.

18 Many of the mutual funds, probably most of the public
19 and private retirement or pension fund administrators simply
20 follow the recommendations of that - of that group. And so
21 to be outside the norm or, you know, out in some kind of a
22 maverick or nonappropriate situation is just simply almost
23 impossible for a compensation committee or a board of a
24 public company to do and remain a board for very long.

25 Q So what is your view as to the value of having - or

1 utilizing outside information and judgment of the
2 compensation committee as opposed to trying to impose some
3 rigid rules on compensation?

4 A Well, I - I think that, again, the ultimate objective here
5 is that Premera is healthy, viable, competitive. And it can
6 be so at best if it has the best management it can attract
7 and retain.

8 And if the - if the committee or the board is restrained
9 in such a way that it is - it is prevented from adapting and
10 taking account of changing practices and so forth within the
11 marketplace, I think personally it would - and I think it
12 could be probably demonstrated - that it could be harmful to
13 the company and to its shareholders, which would, of course,
14 include the final rates being established.

15 And so it is kind of like our electoral process in the
16 country. The shareholders have the ability to change
17 direction by changing directors and I think that that is the
18 ultimate test, that whether the board and the compensation
19 committee is acting in accordance with what is appropriate,
20 reasonable and that sort of thing, and all the other things
21 you would like to see in that activity.

22 Q Would your compensation committee be open to reviewing and
23 discussing some of the discussions that PwC's compensation
24 consultant has raised?

25 A I don't - and I haven't heard a suggestion by any of our

1 committee members that we would reject anything out of hand.
2 We do not believe that those are appropriate at this time.
3 We are certainly going to, as we have been in the past, take
4 varying ideas into account.

5 And we have had some ideas from our own members that we
6 have probably were, you know, held only by that member, but
7 we discussed them at some length. The only idea that I can
8 think was rejected out of hand was one proposed by me. But
9 I do think that the committee would be open to considering
10 those.

11 And it may well be that at some point in time that
12 something suggested could be appropriate, but again, to
13 forecast what the - what the environment will be two years
14 out and set those in concrete right now, would, in my
15 opinion, be unwise and inappropriate.

16 Q One related matter, I guess, in a sense. The PwC report
17 notes that there is a ripple effect when base salary is
18 raised, that to the extent that benefit formulas are keyed
19 to base salary, when you raise base salary, ultimately the
20 amounts of benefits would also be increased. Do you have
21 any comments?

22 A Some of the benefits definitely - and I believe - I believe
23 Mr. Furniss addressed that in his testimony as well. That
24 is the situation, really, within all companies and really at
25 all levels of the organization, not just in the executive

1 management.

2 For example, retirement plans are basically in one way
3 or the other, whether they are contributory or defined,
4 generally a function of levels of base compensation. And
5 that is taken into account. While we do look at base
6 compensation - I don't believe I mentioned this earlier - we
7 spend a great deal of time on the competitive analysis and
8 survey and total compensation for our executives as well,
9 which includes all of the total cash compensation.

10 We also use an outside consultant of the company that
11 does formula benefits to ensure that those are appropriate.
12 And I don't think by any means we have gone to extremes in
13 any of those areas. They are - again, my view is - and I
14 think it is more the outside experts as well as our own
15 consultants, is that we are quite conservative overall and
16 that our plans and programs are reasonable and appropriate.

17 But - but your - I guess your question is does that
18 happen? Yes, it does, but it happens in virtually all
19 companies and virtually all levels of the organization.

20 Q Okay. One final question, from your perspective as a board
21 member, what do you see as the potential benefits of
22 conversion for Premera?

23 A Well, I think a number of those have been discussed. First
24 of all, it is, I think, extremely important for the company
25 to have access to additional capital. And it really doesn't

1 have any avenues that are workable, as has been discussed, I
2 think, by Ms. Jewell and others, to achieve that, which is
3 why after a great deal of discussion and analysis and,
4 again, input from professionals, investment bankers and
5 others, the company chose to do that.

6 So I think it would be - it would be important to the
7 future health, viability and growth and competitiveness of
8 the company to have that access to capital, which conversion
9 to a public company would provide.

10 It would also, in my opinion and I think that of others,
11 be extremely beneficial in the long run as well as in the
12 short run to our members and insured who would benefit from
13 a company that is able to grow in order to spread its costs
14 across a wider base of members. Because many of those
15 costs, as you know, are fixed and obviously a broader base -
16 we can - we can help diversify our risk as well as spread
17 the costs.

18 And something that I don't know whether it has been
19 mentioned - I wasn't able to be here for all of the
20 testimony, but I believe that there is a significant benefit
21 to the entire insurance buying public. This morning as I
22 was thinking about it, all of a sudden - I don't know why it
23 popped into my mind, but you may remember the admin of the
24 University of Washington: "You get something out of it
25 whether you go there or not."

1 I think I could paraphrase that and say that "Premera
2 Blue Cross: You get something out of it whether you are
3 insured there or not." Because if there - if there is a
4 healthy Premera in a competitive environment, which I will
5 believe will be fostered by its conversion to a public
6 company, that benefits everyone. It keeps the market more
7 competitive. It fosters innovation by the competitors in
8 order to get one up, if you will, in terms of providing a
9 more attractive health plan.

10 A good example would be the - the, you know, Dimensions
11 which I think has been discussed. Because as that plays
12 out, it is a significant benefit and improvement for our
13 members who are able essentially to design their own health
14 plans. It meets their needs. You can't do that if you are
15 doing it on outdated systems and software and so forth. And
16 the expense of developing those things is huge.

17 And so I think that those are benefits to the insured,
18 to - certainly to the company, to the assurance - insured of
19 the company as well as the insurance buying public. And
20 then there is a significant benefit to the entire state -
21 states of Washington and Alaska, particularly in Washington,
22 which is a larger population of our membership, with the
23 establishment of foundations which have been proposed as
24 part of the conversion, which I think has been estimated
25 by - I don't know by what company - but by the outside

1 consultants and the OIC's consultants to reach a level of
2 well in excess of half-a-billion dollars. That is a
3 significant amount of the largest foundation that we have
4 that is trying to do good work in any kind of social issue
5 in healthcare that I think would contribute greatly in
6 meeting the unmet health needs of the population and for
7 improving healthcare for the citizens of Washington State.

8 Q Very good.

9 MR. KELLY: Thank you. That ends my questions.

10 JUDGE FINKLE: I'm assuming you have a few
11 questions?

12 MR. HAMJE: I do, Your Honor.

13 JUDGE FINKLE: Let's take a break.

14
15 (Brief recess.)
16

17 JUDGE FINKLE: Let's resume.

18 MR. KELLY: We all set?

19
20 CROSS-EXAMINATION
21

22 BY MR. FAHEY:

23 Q Mr. Fahey, my name is John Hamje.

24 A Good morning, Mr. Hamje.

25 Q Good morning. I'm the Special Assistant Attorney General

1 appearing on behalf of the OIC staff. I wanted to first
2 talk a little and ask you a question or two about some
3 statements you made in your testimony this morning, or at
4 least that relate to statements that you made this morning.

5 I wanted to make sure, is Premera currently in a
6 competitive environment?

7 A I believe that it is, yes. There are a number of providers
8 of health plans and health insurance in our market areas and
9 we find it quite competitive.

10 Q And is Premera healthy right now, too?

11 A Premera is healthy. It is above the minimum requirements
12 and so forth. We think that a more comfortable margin would
13 be prudent, but it is healthy.

14 Q And you don't see either the competitive environment or the
15 health of Premera changing after conversion, do you?

16 A I don't - I haven't thought about whether the competitive
17 environment would change, although I think it is reasonable
18 to assume that it will at least remain as competitive and
19 possibly increase.

20 There are a number of other companies that are much
21 better capitalized that have the ability to - to compete
22 very aggressively against Premera and I think that Premera
23 could itself then become more competitive with additional
24 capital over time.

25 Q Aside from your services as a director, do you have any

1 ongoing business dealings with Premera or any of its
2 affiliates?

3 A I do not.

4 Q Has that been the case since 1998?

5 A Well, I have not directly had them. The company Pacific
6 Northwest Bank was a - had had as its provider for its
7 employee health plans Premera Blue Cross. Those were
8 arrived at through an independent broker that we retained
9 who got competitive bids.

10 I did not participate in the human resource group that
11 was reviewing and analyzing those bids, although I did at
12 the very end assure myself that they had indeed done a
13 thorough process and came up with what was the most
14 competitive plan for our employees.

15 Q Does your current employer, Wells Fargo Bank, have an
16 ongoing relationship with - relationship with Premera or any
17 of its affiliates?

18 A Not that I'm aware of. Its primary provider is United
19 Healthcare, but I haven't been with Wells Fargo for very
20 long either, so . . .

21 Q How long have you been with Wells Fargo?

22 A We closed the merger with Well Fargo on October 31st of
23 2003.

24 Q The provider of Premera's relationship with respect to
25 Pacific Northwest, is that still ongoing or has that since

1 been --

2 A It is not, no. It has not been since the merger.

3 Q So it ended in 2003?

4 A Yes, and I don't believe our plan was of sufficient size to
5 be viewed as material by the company.

6 Q You talked about that being an independent director means
7 that the director has no material relationship with Premera;
8 is that correct?

9 A That is correct.

10 Q Would you please describe the specific criteria for
11 eligibility as an independent director at Premera?

12 A Well, that is the primary criteria, that one does not have a
13 material relationship with the company, is not employed by
14 the company - I believe that it stretches to immediate
15 family members who might be employed by the company, I'm not
16 positive about that in terms of the actual regulations, but
17 it seems prudent to me that that should be the case - and
18 has no - engages in no activity that is competitive with the
19 company or would present - prevent, rather, any other
20 conflict of interest as acting independently as a director.

21 Q Can you give me an idea of what is meant by the term
22 "material"?

23 A Well, the material - the materiality doesn't necessarily
24 have a strict definition, but I think that is one that would
25 have a significant impact positively or negatively upon the

1 company's performance or financial results. We were
2 certainly not a huge part of the million-plus subscribers
3 that Premera has.

4 Q I understand that Premera has a written philosophy of
5 executive compensation; is that right?

6 A Yes, it does.

7 Q And it has been approved, of course, by the board and the
8 compensation committee; is that correct?

9 A Yes, it has. It was developed by the compensation
10 committee.

11 Q Developed and recommended to the board by the compensation
12 committee?

13 A Correct.

14 Q And is Premera's executive compensation philosophy intended
15 to cover all elements of the executives' compensation?

16 A Yes. It's designed to address the issue of total
17 compensation for our executives.

18 Q And that includes base salary?

19 A Yes, it does.

20 Q And annual and long-term incentives?

21 A Yes, it does.

22 Q Deferred compensation?

23 A Yes.

24 Q Nonqualified benefits?

25 A Nonqualified in what sense? In supplementals and so forth?

1 Q Yes.

2 A Yes.

3 Q Those - yes. Those are the retirement plans I'm talking
4 about.

5 A Yes.

6 Q Prerequisites?

7 A Yes.

8 Q And termination treatment?

9 A Yes.

10 Q That includes change in control benefits; is that right?

11 A Yes, it does.

12 Q Now, I understand that in connection with fixing the
13 compensation for Premera executives, the committee reviews
14 an analysis of compensation offered by a peer group of
15 health plan industry companies; is that correct?

16 A That's correct.

17 Q Does the committee include in its review a peer group of
18 companies for the purpose of gauging Premera's executive
19 management's performance in terms of how Premera's
20 performance compares with that of the peer group companies?

21 A Are you asking if that's part of the survey or if we take
22 that into account?

23 Q Is that something that you include in your consideration?

24 A Absolutely. The performance of the company impacts very
25 significantly on the short-term and long-term incentive

1 plans. And we also take into account the individual
2 performance of individual executives in establishing their
3 specific individual level of compensation.

4 Q Is - is it the same peer group that you utilize in looking
5 at the compensation levels that you utilize in comparing
6 Premera's performance?

7 A Well, we do. We would probably - I can't say that we
8 wouldn't have looked at the overall performance with the
9 entire industry. But specifically we do look at the ones
10 that we are comparing and are provided with information on
11 their performance, operating margins, efficiency ratios and
12 various other factors.

13 Q Is this practice competitive with your past practices since
14 you have been on the board?

15 A Well, I - I have not been on the compensation committee that
16 long, but on the board, yes, as far as I know, I think - I
17 think I mentioned in my previous testimony that this board
18 set out on an effort to adopt best practices, at least I
19 believe six years ago or thereabouts. And I have been on
20 the board about five-and-a-half years.

21 Q But it certainly has been consistent since you have been on
22 the compensation committee; is that right?

23 A Yes, it has been.

24 Q Prior to approving the CEO's compensation package, does the
25 committee review competitive compensation data?

1 A Yes, it does, provided by Mercer Consulting.

2 Q And this is also consistent with past practices since you
3 have been on the compensation committee?

4 A Yes, it is.

5 Q Prior to approving the CEO's compensation package, does the
6 committee review peer company performance data as well?

7 A Yes, it does.

8 Q Is this also consistent with past practices since you have
9 been on the committee?

10 A Yes.

11 Q Does the committee receive a performance benchmarking
12 analysis along with the compensation benchmarking analysis
13 from your consultants?

14 A No, that is something we really develop from information
15 that is available that's - that allows us to look at the
16 averages, median and mean and so forth, of operating ratios
17 that we take into account. And we look at such things as -
18 where we may not be at a level that we would seek to be at,
19 the kind of progress that has been made from where the
20 company started to address that particular objective, that
21 sort of thing, typical of what you would do in assessing
22 anyone's performance.

23 Q Is it that your consultant does not provide you with that
24 information? Does someone else prepare it for you?

25 A Well, the consultant will certainly comment on it, but there

1 are industry publications that address that. Most of us
2 spend a fair amount of time outside of our board - direct
3 board activities reading publicly available articles,
4 information, reviewing reports of other companies where they
5 are public and so forth.

6 Q Is the information prepared and submitted to you by
7 management?

8 A We do receive on a quarterly - well, not quarterly, but at
9 our board meetings regularly information that provides
10 performance and ratios and so forth for a number of other
11 companies.

12 Q And I understand the committee sets and approves the CEO's
13 annual compensation; is that right?

14 A Yes, it does.

15 Q And that includes all of the elements I discussed with you
16 before; is that right?

17 A Yes.

18 Q Has this been the practice ever since you have been on the -
19 on the committee?

20 A Yes, it has.

21 Q And it is done on an annual basis?

22 A Yes.

23 Q What about the compensation - total compensation structure
24 of all executive officers at Premera? Is it also performed
25 by the compensation committee?

1 A Yes, it is.

2 Q And you --

3 A And we establish the plans, review the performance against
4 the plans and take the same factors I discussed earlier into
5 account, the - of the ranges, parameters and qualified,
6 nonqualified plans and so forth for the entire group.

7 Q Is this also done on an annual basis?

8 A Yes, it is.

9 Q When the committee sets performance goals for Premera's
10 executive management for the upcoming year, or upcoming
11 planning year, does it use historical and forecasted
12 performance as well?

13 A It does, as well as looking at, again, some computer
14 information to see what see what the competitive companies
15 or comparable companies are performing at.

16 And in that sense, there is of course, obviously an
17 annual budget that is not developed by the compensation
18 committee. It is developed by - it is proposed to the
19 board. And I can tell you it has a thorough going over, in
20 which case that becomes essentially the short-term
21 objective.

22 There are also long-term objectives that come into play.
23 Those are, again, established based on as you mentioned the
24 historical data; where have we come from, where are we
25 trying to get to and what is a reasonable objective for the

1 current year as well as for the long-term incentive program
2 over the next several years based on where we are and where
3 we need to get.

4 Q Does the committee give more weight to historical or
5 forecasted performance if any - if not equally?

6 A Well, we don't simply accept the forecasted performance if
7 we don't believe that the forecast is meeting the objective
8 that we are - that we are after. And so we don't simply set
9 the forecast as the objective that will produce any
10 particular trigger in the compensation program.

11 We will set an objective. And it is intended to be a
12 stretch objective, not just a forecast. So, in other words,
13 I think you might say - this is my personal philosophy and I
14 think it is shared by the compensation committee - the base
15 compensation is for doing the job respectfully and well.
16 And the compensation is for something beyond simply holding
17 the seat and keeping it warm.

18 And base compensation doesn't do that either. Base
19 compensation is dependent on the person keeping their job.
20 And If they do that, they have to do it well. And we have
21 pretty high standards for performance. And so just simply
22 saying you met the plan and if it was a slam-dunk plan is
23 not something that warrants, in my opinion - and I think
24 that's our philosophy - of additional incentive
25 compensation. The incentive compensation is to award for

1 something above and beyond something that happens by the
2 passage of time.

3 Q So I want to try to understand the answer to my question.
4 Is there - is there any weight given, different weight
5 between historical and forecasted performance in setting
6 performance goals?

7 A Well, the weight would be given, again, not so much,
8 Mr. Hamje, to the forecast, I don't believe, but to the
9 objective that we are seeking so achieve. And that would
10 receive much heavier weight.

11 And where we have been is - is the performance that has
12 already been achieved and which presumably has been rewarded
13 or not rewarded depending on what occurred. Where we need
14 to get to is what we are trying to incent, if you will, by
15 the incentive compensation.

16 And so where we have been is a guide to what we might be
17 able to achieve and might reasonably effectively achieve,
18 but it doesn't receive as much weight as the objectives
19 based on historical as well as forecasted.

20 Does that - am I getting at your question?

21 Q Yes, it does.

22 And the does the committee look at any external
23 benchmarks in establishing performance goals?

24 A Well, we do because we look at, you know, what are
25 reasonable expectations in terms of customer satisfaction

1 levels. For example, there are benchmarks established by
2 the Blue Cross/Blue Shield Association, which we set as
3 minimum standards that we will accept and for which will we
4 incent. And there has been significant improvement in those
5 results for the company.

6 I like to think it was in part because of the
7 incentive - well, the portion of the incentive plan that
8 relates to that. But where we have growth in membership,
9 for example, and various other ratios that we might take
10 into account and those can vary from year to year.

11 If we successfully see the company achieve a particular
12 benchmark or result, obviously, you know, you don't just put
13 that one away. You need to maintain that. Now we add a
14 little something extra just to keep the pressure on these
15 folks. So it could be different depending on where the
16 company is and where it needs to go and weighting a
17 percentage - percentage weighting for a particular factor
18 could vary based on the committee's judgment of how the plan
19 will align with our short and long-term objectives and going
20 forward.

21 Q But aren't you now just talking about internal benchmarks,
22 about membership growth, customer satisfaction?

23 A No.

24 Q I don't -I'm really trying to ask about benchmarks that
25 might be set with respect to some of your competitors --

1 A Right.

2 Q -- where you fit in the marketplace.

3 A No, I didn't mean to imply that. We actually look at -
4 pardon me, I have got a bit of a hoarseness here.

5 We actually attempt to look, for example, at what is the
6 average member satisfaction percentage result for the Blue
7 Cross/Blue Shield Association. And we don't want to be just
8 average. And so we may set the benchmark and that benchmark
9 would be what all of the BCBSA companies are doing. And we
10 may set the target above that level for which there would be
11 an incentive if - if achieved.

12 And, again, I think there has been significant progress
13 and improvement in that particular ratio. As an example, we
14 could also look at operating margin, you know, various
15 expense ratios, growth in membership compared, perhaps, with
16 the growth of our other competitors in the marketplace, are
17 we taking market share and so forth.

18 Q Is this consistent with practices since you have been on the
19 committee?

20 A Yes.

21 Q Does the committee work with the audit committee in
22 establishing performance goals?

23 A Not specifically with the audit committee. Well, in one
24 sense we have the information from the audit finance
25 committee that is scrutinizing the budget as proposed and

1 making recommendations and changes. And we also have the
2 information from the discussions of the board about how
3 reasonable and appropriate that budget is.

4 We do - the company's auditor does, in fact, review the
5 results that will be used in calculating the bonus
6 percentage to be applied, if any. So we don't just take
7 that from management and use it as a basis.

8 Q You also talked about the charter of the compensation
9 committee?

10 A Yes.

11 Q That charter is also written; is that right?

12 A Yes, it is.

13 Q Does the committee complete a self-evaluation on an annual
14 basis?

15 A The committee itself has not at this point completed a
16 formal self-evaluation. We have a great deal of discussion
17 about our operations and the way we are operating.

18 The board, does, however do - generally I do a
19 self-evaluation of how it is doing. And there is no reason
20 why we wouldn't do that, but I think we - we have sufficient
21 discussions to, I think, understand how we are operating,
22 how it conforms to best practices as well as in other norms
23 and so - it is pretty small group, so we have a lot of
24 interaction.

25 Q Do members of the compensation committee receive any direct

1 enumeration for their service on the committee in addition
2 to what they may receive for their service as directors?

3 A All committee members have - there is payment for attendance
4 at a committee meeting. Ours is no different than that for
5 the other committees.

6 Q Can you tell me what that amount is for attending a
7 committee meetings?

8 A Well, let's see. I believe the attendance at a committee
9 meeting is - I'm going to say \$800, I believe. I may be
10 wrong in that there is a difference between attendance in
11 person and attendance by teleconference, if required.

12 And attendance by teleconference is not encouraged, but
13 sometimes, particularly in the last year or so with a number
14 of things going on and reviewing all of these things,
15 sometimes that has been required, but . . .

16 Q In your prefiled direct testimony, which is P-48, at Page 4
17 you testify that none of the members of the committee have a
18 material relationship with Premera.

19 A Yes, I did.

20 Q Do you recall that?

21 A I do.

22 Q Are you aware of any members of the committee who have a
23 supplier or buyer relationship with Premera of any kind?

24 A Supplier or buyer relationship?

25 Q Yes, supplier of services or buyer of services.

1 A No, I'm not. Oh, other than the previous situation where
2 Pacific Northwest Bank was a subscriber.

3 Q I'm just talking about the current situation right now.

4 A No.

5 Q And what about their employers, are you aware of any
6 member - any members whose employer have a buyer-supplier
7 relationship with Premera at the present time?

8 A You know, I would have to say I'm not explicitly aware of
9 that. I cannot say that that does not exist where one of
10 the companies might be a subscriber, but I don't recall that
11 they are.

12 Q What steps are taken to ensure that each member of the
13 committee continues to be eligible for membership?

14 A Well, that's reviewed each year at the time that we consult
15 with committees for the following years. No one is
16 guaranteed to be on it I think anymore - anymore than they
17 are on the board, I guess.

18 But each year the committees are reviewed and with
19 specific attention paid to by the nominating committee, not
20 by the chair of the committee, as to the qualifications for
21 membership. For example, on the audit committee, there is
22 specific independence requirements there and financial
23 expert requirements. They are Sarbanes-Oxley and we try to
24 follow that.

25 And certainly the compensation committee, the same thing

1 is taken into account by the nominating committee. And I
2 think that in itself is a rather independent process. No
3 one comes to me and asks me "Who would you like to have on
4 your committee?"

5 It is a process of - of trying to select the best
6 people, spread the load of the committees as well as to
7 ensure some rotation because it is very helpful for
8 individual board members to gain additional insights into
9 specific areas of the company by being on different
10 committees for different periods of time.

11 Q During this review process, how is the information about
12 continued eligibility elicited from the members of the
13 committee?

14 A Well, each year every board members fills out a
15 questionnaire that - and I'm not certain whether that may be
16 required, in fact, under the Commissioner's regulations, but
17 I think that it might be. And it relates to any kind of
18 activity that might present, a conflict of interest or
19 whether or not there are - there is any direct benefit being
20 obtained by any member of the board.

21 So it applies to all board members to determine their
22 ability to serve in the nonconflicting environment and to -
23 and to not personally benefit from their actions as board
24 members. For example, the approval of a contract for
25 someone who might have an interest. If there were a

1 conflict developed, the person would have to recuse
2 themselves and fully disclose it, but I have not seen that
3 occur, so . . .

4 Q And is this process something that has been utilized since
5 you have been on the compensation committee?

6 A It has been utilized since I have been on the board.

7 Q Are materials pertinent to the committee's meetings provided
8 to you and the other members in advance of the committee's
9 meetings?

10 A It would be very rare that that didn't occur. Only if some
11 form of urgent or emergent proceeding were required, in
12 which case the subject matter would be certainly identified
13 in advance, but I don't personally recall - I mean, there
14 may have been a time when some additional information was
15 brought to the committee to supplement, but I believe that
16 the company does a very fine job, as good as I have ever
17 seen, of getting good notice, good information out to board
18 members and the committees well in advance and giving us an
19 opportunity to review and prepare questions and so forth.

20 Q What has been the practice in terms of the time in advance
21 of the meetings that the materials have been received by you
22 and other members?

23 A Let's see. We have got a board meeting coming up and I
24 believe that I have already had that information maybe a
25 week or so. That board meeting I think will be held this

1 week.

2 Q Of course, I'm --

3 A Next week. I'm sorry.

4 Q I'm asking about the compensation committee materials.

5 A The competency committee materials generally are received,
6 oh, probably at least a week in advance in most cases.

7 Q Do you consider this to be sufficient time to allow for
8 adequate review prior to the meeting?

9 A I do. Frankly, I think that's probably more than would
10 occur in many companies.

11 Q Are materials that are provided to the committee members,
12 have they been previously reviewed and approved by the CEO?

13 A Well, certain - no. Certain information wouldn't have been
14 available to the CEO. The report that I receive from - and
15 I receive it directly by mail from Mercer - is not shared
16 with the CEO and - nor are the conversations that I have
17 with the - with that firm or other information that will
18 result in our deliberations on his compensation.

19 Q What about any other employee of Premera? Does another
20 employee - any other employee - is one involved in approving
21 these materials before they get to you or other committee
22 members?

23 A The - oh --

24 MR. KELLY: I will object. Assumes facts --

25 A -- go ahead, sorry.

1 MR. KELLY: My objection is that it assumes fact in
2 evidence. What is meant by "approval"? Object to the form
3 of the question as vague.

4 JUDGE FINKLE: Overruled. Answer if you are able.

5 A What - let me clarify the question. Was the question
6 whether any other member of Premera management approves the
7 contents of the material coming to the compensation
8 committee? Is that your question?

9 Q (BY MR. HAMJE) Yes, sir.

10 A The answer, to my knowledge, is no.

11 Q Mr. Fahey, will executive management's compensation be
12 higher than current levels after conversion?

13 A No, I do not believe it will be, if you mean as a result of
14 a conversion. I presume that if one of them are lucky,
15 might earn a raise next year, but it won't be because of
16 conversion.

17 Q And that is what I intended to ask. As a result of
18 conversion, will executive management's compensation be
19 higher than current levels and I understand your answer was
20 no?

21 A The answer is no.

22 Q What specific initiatives are planned by Premera for the
23 proceeds of the IPO after - if a conversion takes place and
24 afterwards?

25 A I'm not aware that there are any specific initiatives right

1 now, but there is, I think, good reason to - more than good
2 reason to expect that there will be a number of activities
3 that will be facilitated by the use of that capital as there
4 have been over the past when capital has been available.

5 So the approach, of course, will be to look at the
6 needs, environment, the improvements that need to be made
7 and all of the other things that I know have been discussed
8 in testimony, and to prioritize them based on the best
9 allocation of resources, both human resources as well as
10 capital resources.

11 So I would just assume - maybe I shouldn't speculate
12 here, but it would seem to me that one of the great needs
13 will be a continuing maintenance and updating and refinement
14 of our operating systems and procedures and policies and so
15 forth.

16 Q What initiatives have been shelved or delayed as a result of
17 Premera's being constrained by capital?

18 A Well, I think that it is fair to say that we may have been a
19 little behind the eight ball in terms of upgrading the
20 systems, in terms of bringing together the systems.

21 The company was hampered greatly by the Legacy systems
22 that were insufficient. Steps have been taken to improve
23 that, but I don't know that it has given us the final answer
24 yet. And I don't profess to be an expert in that, but I can
25 tell you from my own experience that it seems like those

1 darn systems never stop and stay steady because somebody out
2 there, particularly among our competitors, is always coming
3 up with an improvement.

4 And you don't just have to follow the pack, but you have
5 to pick and choose one as required to maintain your
6 competitiveness and to provide the level of service expected
7 by your subscribers. And I believe in this kind of
8 fast-moving business environment that we are in, I don't see
9 any letup in that - in that activity.

10 The important thing, though, that I believe was
11 mentioned earlier was - that I firmly believe and others
12 have testified - the company needs to grow. And a company
13 that doesn't grow doesn't just stay still. It stagnates.
14 That has been proven time and again.

15 And so the ability to grow could be constrained. There
16 has been similar situations with other kinds of specialty
17 insurance. The that one comes to mind is the medical
18 malpractice situation where companies that didn't act and
19 react appropriately in some cases aren't around or they have
20 left the market or - or couldn't compete effectively.

21 And there has been a situation with the one that was
22 mentioned - the one - I serve on the board of Physicians
23 Insurance where a moratorium had to be placed on new
24 policyholders until the capital situation could be
25 addressed.

1 And so I think certainly the allocation of capital to
2 support growth in membership and in premium dollars because
3 as premium dollars inflate, you know, the aggregate of
4 premiums is what - is what is going to require the capital.
5 And that can come either through growth or through required
6 premium increases based on increasing cost.

7 So for any number of reasons, the company could possibly
8 be constrained from either taking care of its own members
9 and maintaining its membership base or certainly from
10 growing by lack of capital. And the time to get capital is
11 not when you desperately need it.

12 Q You used the example of a moratorium at Physicians
13 Insurance. There has been no such moratorium with respect
14 to Premera, has there?

15 A No, not that I'm aware of.

16 Q Has --

17 A I can't speak to the situation before I became a board
18 member. As you know, earlier on in the '90s there were -
19 there were severe pressures on the company and so I'm not
20 qualified to speak on whether there was a restraint at that
21 time. I could speculate that there may well have been a
22 need to control the growth in premium.

23 Q Has the board of directors engaged in any discussions about
24 what it intends to do with the proceeds of an IPO after
25 conversion?

1 A Well, the kinds of things I just discussed. Certainly the
2 need to grow and the ability to maintain a reasonable growth
3 with the addition of capital. One of the key objectives
4 that was mentioned I think in the early testimony that I
5 heard was the fact while we are adequately capitalized, we
6 are not hugely adequately capitalized, particularly by
7 comparison with a number of the other Blue Cross/Blue Shield
8 Association members because of the various pressures that
9 have been in our environment over the past probably decade
10 or more.

11 And so it is thought to be - and was definitely
12 discussed by the board - to be extremely prudent for us to
13 seek a way to increase the margin for error, if you will.
14 Some adverse event, usually increasing medical costs or
15 something that we could not predict, could suddenly
16 precipitate us being on the watch list or being less than
17 adequately or well-capitalized, which I think would not be
18 in anyone's interest. I know the Commissioner wouldn't like
19 that, I assume, if I may speak for him.

20 But I'm quite certain that it would have an adverse
21 impact on our subscriber members as well as on the insurance
22 buying public at large. For a wounded Premera with our
23 presence in the marketplace to be in that condition will not
24 be healthy for anyone anymore than it is when, you know, the
25 financial area, which I'm familiar with - when the savings

1 and loan crisis was at hand, that wasn't good for anybody
2 And it certainly wasn't good for the public.

3 And so that has been discussed, yes, in terms of the
4 primary objective is to make sure that the company has a
5 capital cushion to be able to meet its obligation to its
6 members, to support continued growth to help us achieve
7 better efficiency as well as to provide better systems,
8 better service, better options and choices for our
9 membership.

10 Q Has the board decided how much it intends to raise through
11 an IPO if the conversion is granted?

12 A Well, I think that final decision hasn't been made other
13 than general discussion. I think the submission of
14 information that relates to generally about 150 million
15 dollars in the IPO.

16 And more than that, I think it would be well to keep in
17 mind, Mr. Hamje, that isn't just this IPO. Going forward,
18 the company, if needed, could have the ability under - as a
19 public company to go to the market for additional capital if
20 it was required.

21 But the one thing that the board has to be careful of is
22 not to overcapitalize the company because it is very
23 difficult to leverage that capital in terms of gaining an
24 adequate return either in terms of improvements that you
25 make or the - or the earnings of the provider sufficient

1 return to investors including the foundations.

2 So you have to pick the right balance. It's - there is
3 no scientific way you can do that. You apply the norms and,
4 of course, sort of common ratios and so forth and you make
5 some judgments about - of what to do.

6 Q If the conversion is approved, will the CEO make this
7 decision with board input?

8 A The decision of how much capital?

9 Q Yes, sir.

10 A Well, he will make a recommendation. He will not make the
11 decision. He will not be the final arbiter of that
12 decision. There will be continuing advice, as we have
13 already had from investment advisers, market specialists,
14 and so forth as to - and our own forecasting and analysis
15 of, first of all, what is needed and matching that up
16 against what is possible and what the market will be willing
17 to place in trust with us, so to speak, for the - for
18 investment on their behalf. So the board will essentially
19 make that decision or approve it.

20 Q Will management and the board make more with rather than
21 without the conversion over time in terms of compensation?

22 A That's impossible to predict. I mean, certainly there will
23 be - there is an opportunity with the equity portion of
24 total compensation to do better, but that is by no means
25 guaranteed. If that occurs, it will be because the company

1 and its shareholders and really all of its constituents -
2 but the shareholders as a group cannot benefit unless all of
3 the constituents of the company are benefiting including
4 customers. If there are no customers, there won't be any
5 return to the shareholders, as you know.

6 So while it is possible, there is absolutely no
7 assurance. I think as Mr. Furniss testified, any options
8 that are granted essentially have zero value at the time
9 that they are granted. The opportunity for those to provide
10 additional reward to either directors or management will
11 come through performance, whether the company is such that
12 it produces an increase in the share value over time.

13 MR. HAMJE: Thank you, Mr. Fahey. That's all I have
14 at this time.

15 THE WITNESS: Thank you, Mr. Hamje.

16 MS. HAMBURGER: We have no questions at this time.

17 MS. McCULLOUGH: None.

18 MR. KELLY: I think I just have two areas.

19
20 REDIRECT EXAMINATION

21
22 BY MR. KELLY:

23 Q One of the questions you were asked was about the - whether
24 the current Premera compensation committee prepares a formal
25 report on its activities. Do you remember Mr. Hamje asking

1 you that question?

2 A I don't recall the specific phrasing, but . . .

3 Q Now, you do report back to the board, do you not, on your
4 recommendations and on the CEO's compensation?

5 A Absolutely. And certainly the board could - in theory,
6 could overrule us. Even though we are charged with that, it
7 will be rather foolhardy to not take that into account.

8 However, in terms of a formal report, we do prepare
9 minutes which are given to the board of directors and
10 ratified by the board of directors so that, in a sense, they
11 are approving what we do.

12 Q Okay. Now --

13 A Not in a sense, they are in actuality doing it.

14 Q Okay. That's preconversion.

15 With conversion, you would be subject to - also to - the
16 company would be subject also to, for example, the New York
17 Stock Exchange governance rules that we talked about a
18 little bit on direct?

19 MR. HAMJE: Objection. Leading.

20 MR. KELLY: I think that's established.

21 JUDGE FINKLE: It is established. Overruled.

22 A The question is --

23 Q (BY MR. KELLY) Would --

24 A -- would we be subject to the rules of the New York Stock
25 Exchange?

1 Q Right.

2 A Yes, we would.

3 Q And do those rules have as a requirement that the
4 compensation committee for a public company provide an
5 annual performance evaluation of the compensation
6 committee --

7 A Well --

8 Q -- if you --

9 A -- I'm not recalling that it is specifically required. It
10 may be. If it is, we will certainly do it.

11 The other thing that I may not have mentioned, if I may
12 go beyond your question, if I may, that is a rule - and when
13 you asked me earlier to list the rules, one that I believe
14 that I may not have mentioned would be that - that we
15 independently retain and - and reach agreement with the
16 outside consultant for their service.

17 Q That would be a New York Stock Exchange rule?

18 A It is, and we use that practice now.

19 Q All right. And then I think the last question Mr. Hamje may
20 actually dealt with is - the last few questions - you were
21 asked about the compensation of the executives after
22 conversion and you indicated that it wouldn't be at a higher
23 than current levels and you - my question to you is is there
24 not an additional component of compensation that is not
25 current now, which is stock options?

1 A If I didn't express that clearly - I thought I did in
2 response to Mr. Hamje's last question, that I thought the
3 first question - and I may have misunderstood it - was will
4 the company's compensation rise as a result of conversion.

5 And stated that way - and I wasn't attempting to be
6 evasive - I think it is true, it will not as a result of
7 conversion. The question then followed, I believe, related
8 to was there - could they make more money. And while I said
9 that is impossible to predict, I don't see a big change or
10 any change really in total cash compensation, but there is
11 an additional component, which I intended to address, if I
12 didn't state it clearly, that includes equity - an equity
13 component.

14 The granting of options in and of itself doesn't provide
15 a dime to anybody unless the value of the stock increases
16 above the market value that the stock had at the time of the
17 granting of the option, as I think has been discussed by
18 Mr. Furniss.

19 And so the opportunity is there, but it is only there if
20 the company does well. And it is only there to any degree
21 if the company does very well, in which case the executives
22 and the board are rewarded for having produced - or having
23 an impact on that success.

24 And because these vest over time, it is not a
25 quick-shot-windfall-type of thing. It is - it's aligning

1 the interests of the executive group with the long-term best
2 interest of the company. And so in time, theoretically and
3 in actuality in some cases that happens.

4 There are many cases - and many examples today
5 particularly where not only have the options not produced
6 anything, but they have harmed the executive where they have
7 exercised the intent of holding, paid the alternative
8 minimum to exit. The stock declines in value and they don't
9 get enough value to pay - repay themselves the taxes that
10 they paid. And that's a horror story that has been written
11 about for some fairly young, aggressive people in the tech
12 world, for example. So - so it is not just a one-way
13 street. There are - there are pluses and minuses.

14 And I would point out - and if I didn't earlier, I
15 intended to - and I think it is responsive to this question
16 and that is that there is no assurance, if you will, that
17 things will change in time such that the balance between
18 long-term and short-term will be changed based on the
19 company's current needs and objectives.

20 And so one of the things I would say also - and I think
21 it has been demonstrated and has been, I think, agreed to
22 without dissent for various people that looked at - is that
23 our equity compensation plan is conservative, quite
24 conservative. And, in fact, it was made more conservative
25 by the board than what the consultants initially

1 recommended, I might add, by taking a look at it and
2 deciding to hold it down a bit.

3 And - and that - you know, we may, in fact, change that
4 not necessarily from our - in fact, we are constrained from
5 doing more, but the elements could be changed in their mix
6 over time to respond to market conditions.

7 And the thing that I think to keep in mind is that the
8 total package is looked at in light of what is required to
9 remain competitive in the market for executive talent and to
10 attract, retain, motivate and align the executives with the
11 objectives of the company. So - so nothing is locked in
12 concrete in that regard.

13 Q And the - for this conversion, is there not a - is there a
14 provision in the Amended Form A such that there is no stock
15 options granted for the first 12 months?

16 A That is true. That was an effort to respond where we felt
17 we could or should to the consultants' reports and so forth.
18 There is a one-year period during which no options will be
19 granted to the executives of the board, which is felt to be
20 more than sufficiently long in a sense that most experts
21 would agree that the stabilization of a stock following an
22 initial public offering would - would undoubtedly have
23 occurred within the six-month period. But a year was put in
24 the plan to respond to the OIC's consultants'
25 recommendations and - and ensure that there wasn't the

1 slightest possibility of sort of a quick windfall.

2 Q Are there additional responsibilities that executives have
3 related to being a public company that also are relevant to
4 the question of they are getting the stock options after the
5 conversion?

6 A Well, I think there absolutely are for both the executives
7 and the board. I mean, we certainly have a high degree of
8 accountability now and liability, but that increases
9 exponentially, in my opinion and from my own experience and
10 I think from recent current events - or recent - or current
11 events. With the - with becoming a public company, you now
12 have a whole new constituency in terms of shareholders.

13 And shareholders are certainly in this day and age not,
14 nor should they be, passive in their scrutiny of the company
15 and its actions and the actions of its board and executive
16 management. You then have some additional regulators beyond
17 the regulators that the company already has who have a great
18 deal of power and some significant enforcement actions
19 available if things are not done properly.

20 And I'm not suggesting that - that that's a reason why
21 we wouldn't do things properly, but even sometimes I have
22 seen people go through quite an ordeal over having done
23 something inadvertently, even which could include civil
24 action by - by shareholders or others and, frankly, subject
25 the directors as well as the executives to personal

1 financial liability that can be significant, that can be
2 real significant.

3 So there are a number of additional pressures, a number
4 of additional obligations and responsibilities that occur
5 with a public company as well as I would say more time to be
6 spent as well as the potential for - for - I won't say
7 unlimited, but certainly significant liability, personal
8 liability.

9 And if you - you may say, well, you can ensure against
10 that. You can get a directors and officers liability
11 policy. That may cover your defense cost and you may not
12 ever have an indemnity or judgment of any kind, but believe
13 me, the pain and the aggravation and the grief of that kind
14 of thing is probably not worth it to anybody in terms of
15 service of the board.

16 Q What is the - what is the positive reason for authorizing
17 the stock options for executives?

18 A Well, the ones that I mentioned certainly in terms of the -
19 there is several reasons, but there are number - and I don't
20 know which is more important than another. The alignment of
21 the executives with the best interest of the shareholders is
22 significant and the reason it is significant is shareholders
23 look at that. They want ownership by boards and executives.
24 And they want an incentive for the company to produce
25 increased market value of the shares obviously. And so it

1 is important to do it for that reason.

2 It is also important for the reasons I mentioned
3 earlier, regarding the ability to attract and retain
4 executives. If we didn't offer them, you know, we would
5 undoubtedly have to make that lack up in some other way,
6 which would be directly costly as opposed to potentially
7 costly assuming that we eventually have to expense options.
8 So that's a factor.

9 And I think that additionally the investment community
10 and the shareholders, investors and funds and analysts would
11 look askance and therefore possibly punish the value of the
12 company in the marketplace, if you will, for the fact that
13 we are out of line and inconsistent with other - with other
14 public companies.

15 Q Okay.

16 MR. KELLY: Excuse me.

17 That's all I have. Thank you.

18 MR. HAMJE: No further questions.

19 MS. McCULLOUGH: I just have one question.

20 THE WITNESS: I'm sorry. I can't hear you.

21 MS. McCULLOUGH: Sorry.

22

23

24

25

CROSS-EXAMINATION

BY MS. McCULLOUGH:

Q You testified that as a for-profit company the board will be responsible to shareholders; is that correct?

A That's correct.

Q And would that be one of the greatest responsibilities that the board has?

A Well, the fiduciary responsibility of the directors, whether it is for-profit or not-for-profit, is paramount. That's - our responsibility is to - is to, from a fiduciary standpoint, safeguard reserve and hopefully provide reward for the investment that was made.

To say that it is the primary responsibility, in my opinion, doesn't quite tell the whole story because these are not mutually exclusive things. As a matter of fact, I will give you an example. My own company, our mission statement had "return to investors" at the bottom of the pile, not at the top, because that won't happen if you don't do all of the other things right. So I think paramount really is the purpose for which this company was formed, and the that was to provide to our members related to the healthcare. If we don't do that, and we don't maintain our membership, the investors will suffer.

So my view is you do all of the things right that you

1 need to do for the constituents that you have, is ultimately
2 that results into the shareholder who will benefit because
3 the company grows in value and remains viable, competitive
4 and healthy and so forth. So that sounds kind of - I don't
5 know how to define it --

6 Q Okay.

7 A -- but that's just the way it works.

8 Q Thank you.

9 And to whom is the board responsible now?

10 A To whom is the board responsible?

11 Q Right.

12 A I think primarily you could say we are responsible to our
13 members, to the community that we serve based on the
14 purposes for which the company operates and what it was
15 established - I think - I think that's a fair statement.

16 Q Thank you.

17 MS. McCULLOUGH: No further questions.

18 MR. KELLY: Nothing further.

19 MR. HAMJE: No further questions.

20

21 EXAMINATION

22

23 BY COMMISSIONER KREIDLER:

24 Q Mr. Fahey, I'm kind of following on the lines here of peer
25 companies that are used for comparison for determining

1 compensation. If I'm not mistaken, I think there are most
2 recently used five or six different companies that as, so to
3 speak, the peer group that you look to for - as part of your
4 deliberations on determining compensation?

5 A That's approximately correct, yes.

6 Q And if I'm not mistaken, that in the requirements now, and
7 in the application before me, that that particular peer
8 group - peer group will be looked to for several years, two
9 years, I believe, as - and held static as part of
10 compensation determinations?

11 A That's my understanding from the current filing,
12 Commissioner, yes. The only way it would not is if one of
13 those companies ceases to exist in its present form. And
14 there is a substitution. And the potential substitutions, I
15 believe, have been placed in the filing are generally
16 admitted to by the various parties.

17 Q So there is some flexibility with that peer group for - from
18 the standpoint of determinations that would take place as to
19 the - that you would have some flexibility, that, in effect,
20 compensation could be similar, not necessarily the same?

21 A Of the peer group?

22 Q Right.

23 A Well, my understanding - and I think it is the case is that
24 we would not have the flexibility to change the peer
25 group --

1 Q Right.

2 A -- unless one of the companies involved in that peer group
3 was acquired, ceased to exist or whatever. In that event,
4 the - there is a prescription for who could be added, which
5 company could be added to that peer group. So really there
6 is no flexibility on the behalf - part of the board, I
7 believe, to the best of my knowledge.

8 Q I believe that's correct also, that the peer group would
9 remain the same.

10 I was wondering about the flexibility in looking at the
11 peer group from the standpoint of that it could be similar
12 types of compensation packages, the peer group would remain
13 the same, but there would be flexibility in determining the
14 compensation package within that view of the peer group.

15 A Well, Commissioner, yes, if I understand your question
16 correctly, I believe that the answer is that we would - we
17 would look at changes that might occur within the
18 compensation plans of those companies and that would affect
19 our view of what would be an appropriate compensation for
20 our - is that responsive to your question?

21 Q Correct.

22 I'm curious when - with that particular peer group, I
23 believe that Premera has given assurances for two years and
24 I believe some of the outside experts - other experts have
25 suggested three to five years.

1 Do you have an opinion as to the length of time and
2 duration?

3 A I do, Commissioner. I eluded to that I think in indicating,
4 in my view, three years is a pretty long time in the
5 fast-moving environment that business operates in today.
6 And my strong opinion is that it would be as - I think I
7 stated unwise and potentially harmful to constrain the
8 committee in using its very express judgment.

9 I think it has proven a track record of doing a very
10 thorough job in considering all aspects of what is going on
11 in the marketplace and in which others are perhaps
12 attempting to acquire our executives and so forth. So the
13 inability to respond to market conditions, to changes in
14 compensation - as an example, there are changes that have
15 occurred fairly dramatically, as we have talked about, in
16 the way compensation committees operate, based on some
17 unfortunate things that have occurred in relatively few
18 corporations, but they have had a significant impact. And I
19 would find myself unable to foresee what changes and
20 conditions might profess to otherwise change the peer group
21 beyond. But getting out three to five years could put the
22 company in the position of not being able to react
23 appropriately to change in conditions. That's my view.

24 Q I'm curious here, you mentioned also stock ownership and
25 is - will there be a requirement as to stock ownership on

1 the part of New Premera's board?

2 A Well, actually not a requirement per se, other than - well,
3 first of all, it might be well to note that the board will
4 be prohibited from acquiring stock in the initial period
5 following the IPO nor will it receive options.

6 It is highly desirable obviously that board members and
7 executive management own stock. And there are in our - in
8 our plans and in our discussions prohibitions of disposing
9 stock and obtaining new options and so forth prior to
10 one retiring from the board.

11 And so a requirement, per se, I guess it is just a fact
12 that someone who receives those options will continue to
13 hold them. Whether and when they exercise them and by the
14 nature of options would be a discretionary thing once they
15 are invested in them.

16 But I would suggest that it would be difficult to
17 explain to shareholders if directors didn't have some
18 reasonable holding and it would be a subject of discussion
19 at shareholder meetings. And as I mentioned, there are
20 checks and balances and controls in this public environment
21 that place pressure upon boards to do certain things, not
22 the least of which would be to own shares in a company.

23 If you don't - if you are not willing to commit your own
24 resources to the company, then I think it would be
25 questionable how committed one is. And I - from my

1 experience, that would be a significant point of discussion
2 in the nominating committee the next time around.

3 Q And that leads to where I was focusing here. I think stock
4 ownership would be something, as I said, would be New
5 Premera in the future, new directors, but currently how are
6 directors selected for the Premera board? I mean, is
7 there - not under the for-profit structure? And is there a
8 term of office of how long they can serve as directors?

9 A Yes, there is, Commissioner. The first part of question, in
10 terms of selection - since I have been on the board at least
11 and I can't speak to the prior time - the board has
12 established a nominating group, in this case now because we
13 have the executive and governance committee, it is - that
14 group serves as the nominating committee.

15 The executive and governance committee has retained a
16 professional who has experience in identifying board
17 candidates based on the criteria that we have established.
18 And we have discussed and established a general description
19 and expectation for board members.

20 And also we have discussed with that outside
21 professionals, our view of what geographic dispersion would
22 be helpful, what expertise is, perhaps, missing on the board
23 or will be missing in the forthcoming ending of terms and so
24 forth. And so - plus, we ask our directors to come up with
25 possible suggestions of people they think might be worthy

1 candidates for filling a particular position that will be
2 coming up.

3 And based on that we refine it and there are interviews.
4 First of all, there is information based on not just
5 resumes, but personal, confidential references that are
6 obtained by the outside professional. The one we have used
7 is one who is very highly respected and performs that
8 function for a number of for-profit and not-for-profit
9 companies. And I think - so - and we haven't always used
10 the same one.

11 But following that, by dwindling it down to sort of the
12 most likely candidates, meetings are held, discussions with
13 them are held by various members of the committee to both
14 explain what it is the that Premera does, what the
15 obligations, responsibilities and expectations of directors
16 are and then determine their qualification as well as their
17 interest.

18 Usually the interest, at least, is determined by the
19 outside professional first - frequently, without revealing
20 who the company is, but the general nature of their
21 business. And I think that process is worthwhile. I think
22 we have a very solid and very capable board of directors
23 that fulfills its functions appropriately.

24 I think, then, your second part of your question -
25 because I answered the first one in too long a matter, I

1 have forgotten, but I think it had to do with - with --

2 Q How long you could serve on the board.

3 A Oh, that's right. I'm sorry. Thank you. I'm older than
4 you, so that's why.

5 The company has established term limits, which would be
6 three three-year terms or nine years. Those can be waived
7 under certain circumstances, would not likely except in
8 exceptional circumstances. But that is the current term,
9 three years per term and three term limits - three term
10 limits.

11 Q It is my understanding that most public companies wouldn't
12 have a constraint similar to what Premera currently has
13 relative to your tenure of your service on the board; is
14 that correct?

15 A Just from my general information, that - I would say that is
16 generally correct. It probably would not have term limits
17 per se, although increasingly - in fact, in my own company,
18 we had a number of other conditions such as someone who
19 retired more than a particular length of time from active
20 participation in sort of the profession for which they are
21 chosen as a member, someone who is unable to attend
22 obviously by reason of traveling a great deal and so forth.

23 And we have typically - and increasingly I think there
24 an age limitation, not that age is a factor per se, but
25 frequently you will see, perhaps, 75, sometimes 70, the

1 theory being by that point in time, someone is less likely
2 to be as actively engaged in - in the local community or in
3 a business or profession such that they are keeping current
4 and so forth.

5 And those are not always the case and they can be waived
6 for circumstances which warrant it, but - and the other
7 reason, quite frankly, is that it is sometimes necessary to
8 consider whether a board member should continue to serve.
9 And without some means that is preestablished, it can become
10 very difficult - because a board works fairly closely
11 together - to make changes that may be required. I mean
12 candidly, but it is rare that that occurs, but if it does
13 occur, you want a mechanism to be able to not renominate or
14 deal with that, so . . .

15 Q So the current - or New Premera board of directors would be
16 the current board of directors and not subject to the same
17 constraints of term limits as they presently are; is that
18 correct?

19 A Well, you know, I'm not an attorney with respect to the
20 articles that would be in place in the bylaws, but I frankly
21 have not - I don't recall any discussion of changes - I'm
22 sorry - changes in the current three-year - three term
23 limits, which would be a total of nine years.

24 There are pros and cons, one con being that you lose
25 sometimes a great deal of experience and it takes a while to

1 get up to speed. I think it is possible that the board
2 could revisit that in the future, but I - we have not really
3 discussed it at this point.

4 I think right now the feeling is that board needs to
5 carry it through the transition. And there are sufficient
6 openings coming up to replenish the board. And, frankly, I
7 think probably whether or not we change that would be a
8 function of what might be - the prevailing sentiment among
9 investors might be at any given time, Commissioner.

10 Q But if you look to your public company peers, you probably
11 wouldn't see a term limit; is that correct?

12 A I think, in general, that's an accurate statement, yes, sir.

13 Q I'm wondering relative to the limits of director and officer
14 - D & O insurance right now, do you anticipate that that
15 would be the same as a public company or - as opposed to
16 current Premera D & O insurance, or would that be altered?

17 A Well, I don't believe I'm qualified to comment on that,
18 quite frankly. I don't know of any reason why it would be
19 hugely different because the activities are generally the
20 same. The risks for which you might have to invoke the D &
21 O insurance would generally be the same with the exception
22 that you currently are not subject to shareholder actions
23 against the company, but you are - you are certainly subject
24 to actions by others.

25 And that does occur, so I'm surmising it wouldn't - it

1 wouldn't be a huge difference, but there may be some
2 difference. And that's pure speculation, which I shouldn't
3 do up here.

4 COMMISSIONER KREIDLER: Thank you very much.

5 THE WITNESS: Thank you, commissioner.

6 MR. KELLY: Two quick questions.

7
8 REDIRECT EXAMINATION

9
10 BY MR. KELLY:

11 Q The Commissioner began with a discussion of the peer
12 companies and then the substitution of - if any of those
13 peer companies are merged or go out of business,
14 substitution of other companies.

15 And is it correct that the consultants for the OIC staff
16 agreed to that approach and indeed to the names of the six
17 substitute companies?

18 A That is my understanding. I wasn't party to the
19 discussions, but I understand that, yes, that occurred.

20 Q There was also a question about stock ownership by the
21 board. And does that one-year-no-stock-options provision
22 apply to the board members as well as to the executives?

23 A Yes, it does.

24 Q And then you mentioned also that in addition to whether
25 or not you received options, that individual board members

1 would be - let me ask you a question: Could individual
2 board members for a period of time go out on their own and
3 buy stock or --

4 A My understanding is - and I'm - unfortunately, I can't
5 recall the specific time frame, but there is a time frame
6 required under the rules of the exchange for the - following
7 the initial public offering the directors cannot participate
8 in the - in the initial public offering and obtain shares by
9 any means through a broker or otherwise and for some period
10 of time thereafter.

11 I believe it is at least 120 days, but someone more
12 expert than I would really have to comment. It is a period
13 of time that prohibits a director from acquiring shares in
14 addition to the one-year prohibitions on any option grants.

15 Q And the name of the consultant that is used to help the
16 board in the nominating committee, I guess, search for
17 members?

18 A The individual has been George Corchran (phonetic) most
19 recently. There was a previous one whose name I don't
20 recall, hailed out of California. And the board - part of
21 my tenure - might have used others.

22 But Mr. Corchran is highly respected in the Northwest
23 business community and has been very successful in both
24 coming up with candidates and with helping to persuade them
25 to take the risk of becoming a member of the board, frankly,

1 so I think we found that to be a very effective process.

2 Q Okay.

3 MR. KELLY: That's all that I have. Thank you.

4

5 RECROSS-EXAMINATION

6

7 BY MR. HAMJE:

8 Q Mr. Fahey, to whom will the board owe its principle duty
9 after IPO - after the IPO?

10 A Well, it's clear that its principle duty will be the best
11 interest of the shareholders as a fiduciary, but as I
12 attempted to state earlier, that I think it is a - there is
13 a multiple accountability that governs all of its
14 constituents and they are not mutually exclusive, so I don't
15 think that it can fulfill its responsibility to the
16 shareholders without taking into account the well-being,
17 best interest of all the constituents, members, the public
18 at large and so forth.

19 MR. HAMJE: That's all I have. Thank you.

20 MS. McCULLOUGH: No questions.

21 JUDGE FINKLE: That's all?

22 Okay. Let's say 1:50.

23

24 (Lunch recess.)

25

1 JUDGE FINKLE: Ready to proceed?

2 MR. MITCHELL: We call Kent Marquardt.

3
KENT MARQUARDT, having been first duly
4 sworn by the Judge,
testified as follows:

5
6
7 JUDGE FINKLE: Please sit down.

8 MR. MITCHELL: So is this free time now?

9 JUDGE FINKLE: Let's see. It is about 1:30.

10

11 (Laughter.)

12

13 JUDGE FINKLE: Go ahead.

14

15 DIRECT EXAMINATION

16

17 BY MR. MITCHELL:

18 Q Mr. Marquardt, would you please state your full name and
19 spell your last name?

20 A Kent Marquardt, M-A-R-Q-U-A-R-D-T.

21 Q And by whom are you employed, Mr. Marquardt, and in what
22 position?

23 A Premera Blue Cross. I'm executive vice-president and chief
24 financial officer.

25 Q Can you describe your duties as executive vice-president and

1 CFO?

2 A Yes. I have the responsibility for the finance department,
3 actuarial underwriting, healthcare economics and business
4 efficiency systems.

5 Q Please give us an overview of your professional background
6 prior to your current position at Premera.

7 A Yes. I am - started my employment with KPMG Peat Marwick
8 and I was with that public accounting firm for 19 years
9 serving in Milwaukee, Phoenix and Los Angeles. And ended
10 that as a partner in the healthcare consulting group working
11 extensively with a physician groups and hospitals.

12 From there, I went on to the physician practice
13 management industry, was in that industry for three years,
14 and then joined Premera in 1998.

15 Q Mr. Marquardt, your prefiled direct testimony and along with
16 your prefiled responsive testimony have been served and
17 filed in this proceeding.

18 Do you adopt that testimony?

19 A I do with one exception. On Page 32 of the prefiled --

20 Q Is that the prefiled direct?

21 A Yes, it is.

22 This is on Line 18 and it has to do with the
23 independence test. The bylaws actually state that this
24 independence test goes both ways in both directions. So it
25 is not just what happens with Premera, but what happens with

1 the outside company. So should I read in the - what - how
2 this should read?

3 Q If you would, please.

4 A Okay. So "directors independent of the directors not
5 currently employers" . . .

6

7 (Interruption by court
reporter.)

8

9 A Sorry.

10 Starting on Line 16, "A director is independent if a
11 director is not currently under the employ or executive
12 officer of another company that accounts for at least two
13 percent or one million dollars, which is ever greater, of
14 New Premera consolidated gross revenue."

15 And here is the change, inserting here, "or for which
16 New Premera accounts for at least two percent or one million
17 which is ever greater, of the company's consolidated gross
18 revenues."

19 So the definition is meant to go both with Premera and
20 with the other company. And the New York Stock Exchange
21 company mirrors the last half of that definition, so it
22 looks at the external company, not at the Premera company.

23 Q (BY MR. MITCHELL) With that correction, Mr. Marquardt, do
24 you adopt your testimony that has been prefiled - filed and
25 served here?

1 A Yes, I do.

2 Q Premera has also made some drafting corrections, technical
3 corrections to the proposed conversion documents that are
4 incorporated as an exhibit marked P-59.

5 Do you sponsor those corrections, Mr. Marquardt?

6 A Yes, I do.

7 MR. MITCHELL: Mr. Marquardt's prefiled direct
8 testimony has been marked as hearing exam- - excuse me - as
9 Exhibit P-58. His prefiled responsive testimony has been
10 marked as P-60 and the technical corrections to the
11 conversion document has been marked as P-59. With
12 Mr. Marquardt's adoption of that testimony and sponsorship
13 of the corrections, Premera now moves to admit the exhibits
14 P-58 through P-60.

15 MS. deLEON: No objection.

16 MR. MADDEN: No objection.

17 JUDGE FINKLE: Admitted.

18 Q (BY MR. MITCHELL) Mr. Marquardt, you said that you joined
19 Premera in 1998, I guess late 1998. Can you describe in
20 brief how the financial position of the company has changed
21 since you joined it?

22 A Yes. When I joined the company, we were in the midst of a
23 financial turnaround. The company had lost considerable
24 amounts of money in the mid '90s due to some market
25 conditions in the individual market in Washington.

1 During the late 1990s we had turned the company around
2 to operating profit and making operating income and setting
3 the stage to take us to the next level, and that started in
4 2000 with the Dimensions program that you have heard a
5 little bit about.

6 Q Mr. Marquardt, from your perspective as CFO, why is Premera
7 seeking to convert to a for-profit company?

8 A Well, actually I have a slide that I would like to share
9 with you on that.

10 Q That would be the slide that is behind you, Mr. Marquardt, I
11 hope?

12 A Yes, it is.

13 And this really deals with a couple issues. One, why is
14 it good for the subscribers? And we believe that by
15 strengthening our reserves to meet future - current and
16 future obligations, this has significant benefit for
17 subscribers.

18 We also think it is good for Premera in that it would
19 allow us to make additional investments in infrastructure,
20 products and services to provide better service and value
21 and from that we hope to be able to derive additional
22 membership.

23 And we think, as Mr. Fahey had said earlier, to really
24 be a successful company you need to continue to grow. And
25 we think not only the current, but future, potential

1 membership is important criteria for us.

2 Q Where is Premera currently relative to its capital position
3 in comparison with other Blue plans, Mr. Marquardt?

4 A If you go to the next slide, it will show where we currently
5 are. And this slide shows the systemwide average for the
6 Blues system at the end of 2002 at 626 percent and Premera
7 at the end of 2002 was 406 percent.

8 Now, the most recent data footnoted here is that the end
9 of 2003 we were at 433 percent. The systemwide average for
10 the Blues system was 712 percent. So even though we have
11 grown our RBC by 27 points, from a relative basis on the
12 system, we have actually lost a little ground.

13 At the end of 2002, we were 35 percent below the
14 average. At the end of 20003, we are 39 percent below the
15 average. Also on this slide we have shown the BCBSA early
16 warning level of 375 and the statutory minimum and BCBSA
17 delicensure requirement of 200 percent.

18 Q Were you responsible for the financial projections that are
19 in the Amended Form A?

20 A Yes, I was.

21 Q Do you have any comments about how those comments were
22 developed?

23 A Well, they were developed with a lot of thought as to what
24 we thought the company could do over the next five years.
25 And, you know, we really tried to look at what the potential

1 for the company was and what - what the growth opportunities
2 were and what that impact would be on a risk-based capital.

3 So as - the critical assumptions that we went into were
4 what could we grow the business and the assumption is that
5 we could grow top-line revenue 15 percent a year. And
6 that's a combination mixed of growth in membership and
7 healthcare cost trend.

8 Now, as Ms. Novak had said earlier, as you grow your
9 healthcare costs, you have to match that with statutory
10 capital, so if - if we keep our medical loss ratio in the 84
11 percent range, our healthcare costs - what we pay to
12 providers is going up 15 percent a year.

13 To keep our RBC in a constant or relatively constant
14 state, we have to grow that income 15 percent per year to
15 basically tread water. So the outcome of this - now, there
16 are a lot of other factors that go into the risk-based
17 capital, but the principle of beating the healthcare cost
18 component, we stay in the RBC level of between 400, 450
19 percent with the projections that we filed in the Form A.

20 Q Mr. Marquardt, are there circumstances in which you may not
21 be able to tread water in the fashion as suggested by these
22 projections?

23 A Yes. The next slide lays out certain scenarios that we have
24 analyzed. And what we tried to do here was look at what
25 could potentially impact where we think we could go. And we

1 ran through four different scenarios that I'm going to walk
2 you through here in a second and compared it to where we
3 were and compared it to where the BCBSA's early warning of
4 375 was.

5 Q Let me interrupt you just for a second and ask you where you
6 came up with these scenarios?

7 A These scenarios were based on kind of expectations of things
8 that had happened in the past and things that potentially
9 could happen or had happened in the past or could
10 potentially happen in the past or future, so . . .

11 Q Please continue.

12 A The first - the first scenario was if we were to have
13 additional growth. And back in the year 2000 we grew the
14 business by a similar amount, which actually grew our
15 membership about 12 percent and grew top-line revenue 20
16 percent. And we had a drop in our RBC ratio of over 100
17 points.

18 So we tried to project out what could happen in the
19 future in 2004 and '05 if we ran 12 percent growth
20 membership as a hypothetical standpoint. And the impact of
21 that is that our risk-based capital would drop to 360
22 percent from where it is currently.

23 The second scenario was what would happen if there was
24 no investment income. And we have seen in the past where
25 the investment markets have been rather not too robust, I

1 guess. And this is a possibility that could happen in the
2 future that would have a negative impact on us. The impact
3 we calculated was that risk-based capital would be 355
4 percent.

5 The third scenario was what would happen if we had an
6 acquisition opportunity. And in the past when we have had
7 opportunities to acquire another company, we have been
8 somewhat constrained by our capital. We have had
9 opportunities in the past to talk to the Northwest Medical
10 Bureau that later merged into the Regence company. We have
11 looked at KPS which went into Receivership. And we have
12 looked at other things that really have been limited.

13 So this scenario was to look at a 100,000 member
14 insurance health plan coming into us at an average price of
15 \$300 per member and that would take our RBC level to 350
16 percent.

17 The fourth scenario is what would happen if the
18 operating income downturned. And we looked at kind of a
19 long-term historical look back and said, you know, for over
20 what period have we hit like a break-even point. So we ran
21 a break-even scenario.

22 And this could happen if you miss your medical costs
23 trend. We are trying to run this business predicting what
24 healthcare costs are. And if we miss what that trend is, we
25 could be in a situation where operating income could be flat

1 to zero. So that impact hits us - leaves us at a RBC ratio
2 of 325 percent.

3 Q What happens if more than one of these things happen at the
4 same time or, heaven forbid, you have a perfect storm?

5 A Well, I think you are compounding the effect obviously.
6 These were all hypothetical scenarios that could have
7 potential and - you know, flip the other way on the positive
8 side on some of these things, but you would have a
9 multiplying effect that would put you in jeopardy.

10 Q How much capital do you believe Premera needs at this point,
11 Mr. Marquardt?

12 A Well, if you flip to the final slide here, where we are
13 today at 433 percent, where the system average today at 712
14 percent - we heard Ms. Novak talk about that, you know, a
15 minimum level of our RBC should be at 500 percent. We think
16 the range should be in the 500 and 600 percent RBC.

17 Now, to get to that number from where we are today, we
18 could need 60 to 150 million of capital. And we think that
19 is the right size for us to go out for in the initial IPO.

20 Q Can you obtain such capital from other sources,
21 Mr. Marquardt?

22 A Well, I think we are very limited. I think we have ran
23 through the operating scenario in the Form A where operating
24 income continues to grow and we continue to grow and we stay
25 kind of status quo in the 400 to 450 percent range.

1 Some of the other alternatives that we have talked about
2 in past discussions of selling certain assets or selling
3 certain chunks of the business really don't generate that
4 much capital and would be a one-time event.

5 I mean, there is always the possibility of a merger
6 activity, but, you know, if you merge anywhere with a local
7 company, the only logical entity would be Regence, and I
8 think there would be serious questions about bringing
9 Premera and Regence together in a combined entity from an
10 antitrust concern.

11 And then if you merged with an out-of-state for-profit
12 company, we would be going through the same process to get
13 approval for that. With an out-of-state not-for-profit, I
14 think you would look at giving up your independence and
15 local - local management.

16 So we see the equity opportunity as not only the best
17 option but also an option that creates a recurring
18 opportunity to go back into the markets.

19 Q Why do this now, Mr. Marquardt? You know, Premera is not on
20 the ropes.

21 A Well, you want to be in a strong position to go out to the
22 market. And we think we are in a strong position with a lot
23 of upside in our story. So we think we are a very
24 attractive opportunity for the public markets. And we think
25 there is story to be told, that there is continued upside on

1 the company.

2 Q Mr. Marquardt, in the financial projections that you have
3 done, have you endeavored to show the hopes for returns on
4 the capital that you would plan to raise through an IPO?

5 A Well, we actually did not do that in the financial
6 projections. We did run a hypothetical dilution model for
7 the consultants at their request as part of the due
8 diligence process.

9 Q What about the costs of conversion, Mr. Marquardt? Aren't
10 the costs rather high?

11 A Well, you know, the costs are more than we had hoped or
12 anticipated. It has taken longer and been a much more
13 diligent process than we had kind of originally thought it
14 would be.

15 We originally thought we would be done at the end of
16 last year and obviously we are into May now. But it is a
17 one-time cost and it is still the right thing, from what we
18 believe as a prudent management, to give us the capital
19 flexibility and position ourselves for our subscribers and
20 for the long-term benefit of the company.

21 Q Mr. Marquardt, what are the tax consequences of the proposed
22 conversion?

23 A Well, we have done a lot of detailed look at the tax issues.
24 And to kind of simplify the tax concepts for everybody, we
25 believe that the series of transactions of moving from a

1 not-for-profit to for-profit will not be a taxable event for
2 federal tax purposes. And the transfer of money to the
3 foundations will not be taxable for federal tax purposes.

4 In addition, there should not be any tax benefit on the
5 destacking of the Alaska corporation or on the - there
6 should not be any tax penalty - I shouldn't say tax penalty,
7 tax benefit there. There should be no tax in play on the
8 382 change of ownership at the time of transaction.

9 Q How about state taxes?

10 A We have letters from the Washington Department of Revenue
11 that indicate there would not be any real estate and excise
12 tax or any B & O and sales and use tax.

13 Q You have before you, I believe, Mr. Marquardt copies of
14 Exhibits P-62, P-63, and P-64. Can you identify those
15 documents please?

16 A Yes. P-62 is the letter from the Department of Revenue, no
17 B & O and sales and use tax. P-63 is the letter from the
18 Department of Revenue on the no real estate and excise tax.
19 And P-64 is the Ernst & Young opinion on the federal tax
20 transactions and the representations behind that letter.

21 MR. MITCHELL: Your Honor, we would move the
22 admission of P-62, P-63 and P-64.

23 MS. deLEON: No objection.

24 MR. MADDEN: No objection.

25 JUDGE FINKLE: Admitted.

1 Q (BY MR. MITCHELL) Mr. Marquardt, how will the capital that
2 Premera raises through its own need for the IPO affect the
3 healthcare foundations that are being created through the
4 conversion?

5 A We believe that the - the capital raised through the IPO
6 will - will position the company to be a strong company, but
7 it will also really allow the foundations to go from - I'm
8 sorry, I have lost the question.

9 Q I'm sorry. How will the capital that Premera raises for its
10 own benefit through the IPO affect the healthcare
11 foundations?

12 A We think it has a positive effect on the foundations in that
13 the company will be well-capitalized and will create an
14 opportunity for the foundations to liquidate their holding
15 of the 100 percent of stock that they get on the transaction
16 point.

17 Q And would the foundations be able to sell their stock into a
18 market without the IPO?

19 A No, they would not. To really be able to liquidate the
20 stock that the foundations receive, there has to be a public
21 market and until that happens, the stock really does not
22 have any opportunity for being turned into cash.

23 Q Mr. Marquardt, Premera filed an Amended Form A in February
24 of this year. Can you describe the process leading up to
25 that filing briefly, please?

1 A Yes, I can. The original Form A was filed in September of
2 2002 and it was based on the precedent transactions at that
3 point in time, which we thought were clearly laid out from
4 past Blue Cross/Blue Shield conversions.

5 We went through extensive due diligence through the
6 interim time frame. We actually had another precedent
7 transaction - the WellChoice transaction closed in the
8 interim time frame.

9 The consultant reports were filed in, I believe,
10 September of 2003, September, October, time frame. And
11 there were obviously some differences between the
12 consultants' recommendations and the original filing of the
13 Form A.

14 We were asked then to go into discussions to narrow
15 those differences and those discussions happened in
16 December, January of 2003, 2004. And we made significant
17 progress in narrowing a lot of the differences, but there
18 still remains some items to be resolved.

19 MR. MITCHELL: May I approach?

20 JUDGE FINKLE: Yes.

21 Q (BY MR. MITCHELL) Mr. Marquardt, I have handed you what has
22 been previously marked as Exhibit P-94. Does this document
23 list the disputed issues, the principle ones as least?

24 A We believe it does. And we have tried to bucket these into
25 categories of discussion.

1 Q Using Exhibit P-94, if you would, can you walk us through
2 the transaction terms and explain to us the issues that are
3 in dispute?

4 A Yeah. I will try to summarize those issues for you. The
5 first page talks about duplicative foundation issues and the
6 three major points that are sitting here - we have had some
7 discussions of this in the past from Mr. Barlow - is does it
8 have board members for both foundations, five percent minus
9 one of shares outstanding of the voting trust for both
10 foundations, and then the divestiture schedule.

11 These were all items that we basically concurred with
12 the state consultants on. And I think you remember hearing
13 Mr. Barlow testify of - of the efforts that went into going
14 back to the Blue Cross/Blue Shield Association to try and
15 get their approval on these items. These were all related
16 to the Blue Cross/Blue Shield rules.

17 We were able to get the approval on the first item on
18 adding two designated board members. It still needs to get
19 full board approval from the BCBSA, but we believe that is a
20 likely outcome.

21 The second item on having two - two separate five
22 percent shares, outside of voting trust, one for Alaska, one
23 for Washington, has not been agreed to and was basically
24 turned down by the Association. This one, we have a
25 provision in the arrangement that the one five percent could

1 be split depending on how the states decide to allocate
2 that. If we cannot reach an agreement on that allocation,
3 then we would be okay with it going to Washington.

4 The second - or the last item on here is the divestiture
5 schedule. And this one is where 80 percent would have to be
6 sold after the first year, 50 percent after three years, 20
7 percent after five years and five percent after 10 years,
8 each - the combined total would have to be down to those
9 levels. And the issue here is whether that should be
10 jointly shared or separate. The Association has maintained
11 that it should be jointly looked at.

12 Q If you turn the page then.

13 A On this page we have kind of the other BCBSA licensure
14 issues and this deals with the overall divestiture
15 requirements that I just talked about as to what should
16 happen.

17 I think the main point on this issue is the 20 percent
18 in the first year. And we would propose on this issue that
19 the IPO fill that requirement, that we have 20 percent in
20 the IPO to drive an appropriate level of float in the
21 transaction and to make sure that we hit this divestiture
22 requirement, which should relieve the concern about getting
23 to 80 percent after one year.

24 The second and third item on change in control threshold
25 and term of - the board members were both provisions that

1 when negotiated in WellChoice and the Association has made
2 it very clear that they will not go any further than the
3 WellChoice transaction precedent on these two items.

4 Q With respect to the six issues that we have talked about
5 thus far, Mr. Marquardt, what is your understanding in terms
6 of the ability of Premera to go against the BCBSA wishes on
7 the five of them that remain - the matters that BCBSA has
8 said they will not accept?

9 A I think you heard testimony earlier that the value of the
10 Blue Cross/Blue Shield mark is much more important than any
11 of these items, so we really are not in a position to go
12 beyond this. And, you know, we really have to live up to
13 what the BCBSA has set in other precedents prior to us.

14 Q And if you turn over to the next page, New Premera
15 Governance.

16 A Yes. This list deals with items around the Premera board
17 and governance working with Premera. The first item is a
18 selection of designated board members. And this is really a
19 concern about the veto right on board members being offered
20 up from the foundations to Premera.

21 And I think Sally Jewell had talked about this, that
22 there really needs to be the right chemistry of what the
23 board looks like. So we have a very sophisticated board
24 that works very well together. I think you have seen
25 testimony from those board members. And, you know, we think

1 the board chemistry is key here and we want to reserve the
2 right to veto a board member that doesn't fit into that
3 equation.

4 Q What is your understanding about the equivalent provision in
5 the WellChoice transaction?

6 A This - my understanding is this is equivalent to what the
7 WellChoice transaction looks like.

8 Q I'm sorry to interrupt you. Go ahead.

9 A Thank you.

10 The director independence standard, as I clarified
11 earlier, really complies with the New York Stock Exchange
12 rule. And it is a question of greater of or less than. We
13 have greater than - greater of, which is in compliance with
14 the New York Stock Exchange. We actually go further by
15 flipping it the other way so that it is not only the outside
16 company, but it is with Premera. And we think that is the
17 appropriate criteria to set in deciding independence and
18 that goes to a so-called higher standard by going lesser of.

19 And let me give you an example of that. You know, we
20 want representation from our customers. And Mr. Fahey who
21 testified earlier, testified that Pacific Northwest Bank was
22 a customer of ours. If it would have gone to the lesser of
23 standard, he would not have been qualified as an independent
24 director under a lesser of standard. And we don't think
25 that's an appropriate level.

1 The final item is survival of the voting trust. And
2 this is an issue that if we were to lose the mark - the Blue
3 Cross/Blue Shield Association mark, that the voting trust
4 should go away.

5 Now, WellChoice does have that provision in it. We
6 believe we were in a different situation than the WellChoice
7 transaction. We believe that in the market that we are in
8 with overlapping service areas with the Regence plan, that
9 we are in a much different situation than WellChoice is.

10 Now, I think everybody is in agreement that the
11 possibility of the voting trust going - or the mark going
12 away is a pretty remote possibility, but if that were to
13 happen, that's when you really want your subscribers
14 protected and to have a board that is experienced in running
15 an insurance company, not in running a foundation. So we
16 think this is an important criteria for protection for our
17 subscribers.

18 Q The next page talks about foundation governance.

19 Mr. Marquardt, can you tell us what this is about?

20 A This deals with governance issues around the foundation.
21 And I will quickly run through these and try and summarize
22 them. The first concept was having three boards. And we
23 really anticipate having an initial board that would go
24 through the incorporation and do the tax filing. And this
25 would be preapproval, preseed money, Premera would pay the

1 freight for this. That board would go away after approval
2 of the transaction and - once the second board was appointed
3 by the Attorney General's office.

4 The second board would be responsible for preIPO, to the
5 IPO and would be responsible for the procedures down to the
6 IPO. And we think that board should have, you know, four to
7 five qualified financial type people that can take the
8 foundation through the IPO.

9 The third board would be an expansion of that to get
10 into the grant function development and get into a
11 functioning foundation board.

12 Q Before you go on, Mr. Marquardt, is there a dispute with the
13 state's consultants about having three boards or what is the
14 issue here?

15 A I think there was some concern about having that first
16 board. I'm not exactly clear on what - what - if there is a
17 real concern here.

18 Q Okay. Continue, please.

19 A The third was on qualifications for directors of the
20 foundation. I think there was some clarity that it was
21 interpreted that physicians should not be included in that.
22 We have always intended that the physicians should be
23 included as potential candidates for the foundation board.

24 The third item is the role of the investment committee
25 versus the role of the program committee. In the foundation

1 bylaws, we have set aside provisions for the investment
2 committee to deal with financial functions and provisions
3 for the program committee to deal with grant-making
4 functions. And we think that's important to get the right
5 people in the right place to make those decisions.

6 The next item is on use of proceeds from the stock
7 sales. And we believe the proceeds should go to health
8 needs and not be available for any kind of lobbying efforts.
9 We think that is the intended purpose of this and we think
10 that is the right purpose for it.

11 The next item on lobbying limitations is we don't think
12 it is appropriate to have provisions in there to do lobbying
13 against Premera. We think that money to support lobbying
14 conditions can be raised outside from other money, if that's
15 a needed type of activity. And the foundation should
16 obviously make any calls outside - outside on what they want
17 to lobby before, but we don't think it should be against
18 Premera or the insurance industry, which would be counter to
19 holding, you know, as your major asset the stock of a
20 company and then lobbying against them. So we think this is
21 kind of a - would be a silly thing to do.

22 The final one is on the amendment of the articles and
23 bylaws. And the issue here is we have proposed to amend the
24 articles or bylaws that would require a 75 percent vote of
25 the foundation board and get AG approval. And the concern

1 was if they needed to amend the bylaws or articles for - to
2 get the appropriate tax opinion, this might be difficult to
3 do. We think it is an appropriate protection of the
4 articles and bylaws.

5 Q Okay. We are coming down the home stretch now, right,
6 Mr. Marquardt? Tell us about the Plan of Conversion.

7 A On the Plan of Conversion, the first three items here, we
8 are actually okay with and have agreed to and we believe
9 they have been resolved in the errata that was brought in
10 earlier.

11 On the final one, on the three months extension for
12 pending litigation of the conversion proposal, I think
13 everybody is in agreement that it should extend out for 12
14 months. We think that's a good time frame, but we also
15 would think that having three month extensions - two
16 three-month extensions for potential pending litigation is
17 important criteria. And really to kind of sum this up, this
18 is less likely to be needed if we have it then if we don't
19 have it. We think it would --

20 Q That is a little paradoxical, Mr. Marquardt. Can you
21 explain that?

22 A Well, we think if we have this protection that we are less
23 likely to be put in a litigation suit just to push us past
24 the time limit.

25 Q Are we on to other issues?

1 A We are on to other issues.

2 Q Other questions.

3 A Other questions. We believe that none of these are really
4 material to the interest of our shareholders or subscribers,
5 but let me kind of run you through them and we will explain
6 what the importance of each one is.

7 On the free-voting on stock-based compensation plans,
8 this is - again, there was some fairly confusing language in
9 the document. We are okay with going to the six-month
10 window rather than a 12-month restriction on that.

11 Q So that's either resolved or easily evolved?

12 A I think it is resolvable, so I think it is a little wording
13 challenge in the documents, but we - we are in agreement
14 with it.

15 The second one on pricing input, this is a question of
16 where if the foundation goes out with an offering and
17 Premera pay backs on that offering and wants to do some
18 primary shares, it would run through the Premera pricing
19 committee.

20 Now, on the Premera pricing committee, we would have -
21 one of the designated members would be serving on that
22 pricing committee. There would also be input from the
23 foundation having joint book runners. And then the final
24 decision on this is whether you really want to sell or not
25 at the price recommended. We think that's an okay provision

1 and that gives adequate discussion around the pricing.

2 On the third one, on piggy-back rights, the question
3 here is if we are going out and the foundation piggy-backs
4 on us and we decide not to go forward with the registration
5 statement, the wording is, "to the extent practicable, we
6 would allow the offering to go forward." The legal term -
7 or the proposal by the consultants is "if it is legally
8 permissible." So I think this is a fairly technical point
9 on, you know, what should happen here and really not
10 something that we should be too excited about.

11 The next item is on trustee expenses and this is around
12 the voting trust agreement. This is really - we estimate it
13 as a 15,000 to 20,000 a year annual expense. We have agreed
14 in our discussions to pick up the first year of this and
15 then split thereafter. And I think that's a reasonable
16 position.

17 The next item is on allocated share escrow agent
18 agreements. And we look at this as kind of a failsafe
19 agreement. This was what happens if we can't resolve the
20 allocation between the two states. And just to make it
21 clear, this is only on any portion that is in dispute.

22 So as we understand how the allocation is coming down
23 now, but kind of the hard position is that Washington should
24 get at least 72 percent, Alaska should get at least 12
25 percent, there is 16 percent that is in dispute. That's

1 what would go into this agreement. And we look at it as
2 kind of the failsafe so that the conversion could go forward
3 without getting final resolution of that allocation.

4 And then the final point is on guarantee agreements.
5 And this is actually where New Premera is guaranteeing the
6 subsidiaries' activity. So the new company would be
7 guaranteeing all the claims obligations to support our
8 subscribers. And there is slightly different language
9 between a large-controlled affiliate and a small-controlled
10 affiliate. Our intent to stand behind both these entries
11 and make sure that subscribers are protected.

12 Q Mr. Marquardt, with respect to the last point, the guarantee
13 agreements, are those intercompany agreements subject to
14 Form D?

15 A Yes, they are.

16 Q And are the Form D issues raised by those agreements
17 different from the issues raised by all the other issues you
18 have talked about?

19 A Yes, they are.

20 Q Is there any difference in material effect between the
21 guarantees that have been offered to the new Alaska
22 subsidiary, which as I understand it, is a smaller
23 controlled affiliate as opposed to the Washington
24 subsidiary, which is larger one?

25 A There is some language difference on continue to provide

1 coverage for the small affiliate that is - that is in the -
2 in the Alaska guarantee. And the larger one does not have
3 that same language.

4 Q Do you have an understanding as to whether equivalent
5 protection is afforded under the BCBSA contracts?

6 A It would really be our intent to stand behind both of these,
7 so I don't think this is a big item.

8 Q Now, this is a - looks like a long list of items,
9 Mr. Marquardt. But how does this list compare with the list
10 that you started out with?

11 A We obviously had significant more items. Reading the
12 consultants' reports when they were first issued, there were
13 lots of issues. There was an issue of moving to conformity
14 to the WellChoice transaction. There was an issue of going
15 from one foundation to two foundations. And there were a
16 lot of other items that were raised.

17 We think we have solved the majority of those items and
18 so - as a matter of fact, in the initial discussions, we
19 started with the "Magnificent Seven" list of items that the
20 state's consultants put together. We solved six of them.
21 The one remaining item was the voting trust agreement that
22 we talked about earlier.

23 MR. MITCHELL: Your Honor, we would move Exhibit
24 P-94.

25 MS. deLEON: No objection.

1 MR. MADDEN: No objection.

2 JUDGE FINKLE: Admitted.

3 Q (BY MR. MITCHELL) Mr. Marquardt, is the structure that
4 Premera had proposed in the Amended Form A in its subscriber
5 interest and in the public interest, to your judgment?

6 A We actually believe it's kind of a win-win-win. We think it
7 is in the best interest of the subscribers to have adequate
8 capital to support them. We think it is in Premera's
9 interest to have additional capital to invest in our
10 infrastructure and support additional growth. And we think
11 it creates a valuable asset to the citizens of Washington
12 and Alaska in the foundation for health needs. So we think
13 it is really a win-win-win.

14 MR. MITCHELL: Nothing further. Thank you.

15

16 CROSS-EXAMINATION

17

18 BY MS. deLEON:

19 Q Good afternoon.

20 A Good afternoon.

21 Q You stated that you worked for KPMG Peat Marwick for 19
22 years; is that correct?

23 A That's correct.

24 Q And you were a partner there?

25 A I started out as a staff person, but yes, I was a partner

1 when I left.

2 Q Why did you leave that employment?

3 A I left for another opportunity.

4 Q And that was Prime Med Management?

5 A Yes, it was.

6 Q And what did do you there?

7 A I was the chief financial officer.

8 Q And how long were you at Prime Med?

9 A I was there for a year.

10 Q And why did you leave Prime Med?

11 A I left for another opportunity.

12 Q And that was Med Partners?

13 A Yes, it was.

14 Q And that was in 1996 or thereabouts?

15 A Yeah.

16 Q And what was your - were you a CFO there as well?

17 A I was chief financial officer for the western operations of
18 Med Partners.

19 Q And how long did you stay there?

20 A I was there for two years?

21 Q And why did you leave?

22 A We had a changeover in management and new management came
23 in.

24 Q And you --

25 A And I --

1 Q -- didn't like that?

2 A And I left after that.

3 Q Okay. And you went to American Dental Specialists; is that
4 correct?

5 A Yes.

6 Q And what did you do there?

7 A I - it was a start-up company that we were trying to get
8 venture funding in the late '90s and did not fulfill that
9 opportunity.

10 Q And then you went to Premera from there?

11 A That's correct.

12 Q Okay. And how did you - how were you selected to go to
13 Premera?

14 A I was recruited by - by a headhunter, a recruiter.

15 Q Did you know Mr. Barlow previously to your employment at
16 Premera?

17 A I had met Mr. Barlow in Southern California when he was with
18 AHI.

19 Q Did you have a personal relationship with him?

20 A No, I did not.

21 Q Okay. I believe you stated earlier that there are basically
22 three reasons why Premera was going to convert and one of
23 those was to strengthen reserves; is that correct?

24 A That's correct.

25 Q And is there a point when you have too much reserves or can

1 you just keep adding to that?

2 A Well, there is lots of discussion going around in the
3 country as to what the maximum level or what is the ideal
4 level. I think, as Ms. Novak said and as we have done our
5 research on the whole risk-based capital formula, it doesn't
6 give you the target number, but it is meant to set what kind
7 of minimums you should have.

8 And we believe to get us to a capital flexibility, we
9 should be above a 500 percent RBC level.

10 Q How did you come up with the 500 number?

11 A It was really in discussions with people like Ms. Novak and
12 looking at kind of what we think is reasonable level of
13 protection should be. And it - and it really should be -
14 and that is kind of the minimum. I think the 500 and 600
15 percent is a good range because it's below kind of the
16 average where the world is from Blue Cross/Blue Shield
17 Association standpoint, but it gives you that flexibility.

18 This is a measure that takes into account a lot of
19 variables. So you are impacted by what happens from a
20 growth standpoint, as you grow your business, what happens
21 from an underwriting risk, what happens from an asset risk.
22 And, you know, there is a lot of moving parts in there. So
23 you need some level of flexibility to address all of the
24 inherent risks in running an insurance company.

25 Q You have compared yourself to other companies around the

1 country regarding the 500 to 600 percent and the average was
2 600 and something.

3 Why do you compare Premera, who is in the Pacific
4 Northwest, to other companies around the nation?

5 A Well, I think it is important to kind of look at the overall
6 market. And we think we - you know, every market is a
7 little unique, but you also need to kind of look at what
8 businesses are across the country. And when you look at
9 this risk-based - risk-based capital calculation, it is
10 meant and been adopted by the National Association of
11 Insurance Commissioners as a measure for the whole industry
12 to evaluate what your capital position is and to evaluate
13 what your risk of doing business is.

14 So we think it is an appropriate metric to kind of
15 compare us to other players that are in, you know, Boston or
16 Philadelphia or Southern California. It is a good metric to
17 track risk of our business.

18 Q But you have been able to grow your business with your
19 current RBC level or a little lower, actually, haven't you?

20 A We have been able to grow our business, yes.

21 Q And --

22 A I --

23 Q And without the conversion, would you be able to grow
24 further?

25 A Well, I think, as we have said in the Form A projections, we

1 think we can continue to grow the business four to five
2 percent a year in membership and kind of retain status quo.

3 Now, if we have an opportunity to do better than that,
4 if the Dimensions project really drives additional
5 opportunities for us, we would be constrained to put those
6 in play.

7 Q So it is kind of good news is bad news?

8 A Well, I think it is. If you are a successful company, you
9 have got to kind of plan for the future and position
10 yourselves for the future with adequate capital. And we are
11 like any other company in that regards, and probably more so
12 being in the insurance business that we are in and having
13 kind of a standard to look to. We have to be able to live
14 to that standard and really plan ahead for that.

15 Q Okay. As I recall when Ms. Novak was testifying, she said
16 that based on your RBC of 406 you needed about 72 million to
17 get to 500 percent. Do you recall that?

18 A I think that's right.

19 Q So why do you think that you need now actually more, between
20 100 and 150 million?

21 A Yeah. We actually reran the numbers from where we are now
22 at 433 RBC at the end of 2003 and to get to 500 percent we
23 need 60 million, to get to 600 percent we need 150 million.
24 And we think the preferable number is the 150 million to
25 give us the 600 percent.

1 And the reason for that is, you know, as we look at what
2 we can do with this money, we have heard lots of ideas to -
3 how to - the money should be spent. And Mr. Smit talked
4 about all the informational systems issues that he had. We
5 had Mr. Ancell and Mr. Chauhan talk about additional things
6 for care facilitation.

7 We are currently in the process of assessing all of
8 those options and deciding which options would give us the
9 best return, as Mr. Fahey talked about, and we will be
10 making that decision as we get closer to the IPO. And we
11 anticipate taking some of that 150 million that would take
12 us to 600 percent and spending some of that additional money
13 for those types of activities.

14 Q So you don't currently have a list of things you want to do
15 once - with - with the money?

16 A Well, I think we have lots of ideas. We don't - we haven't
17 firmed up what the priorities of those are.

18 Q Is it my understanding, then, that once the IPO is over and
19 you have the money, that you are going to invest it in bonds
20 in the short-term?

21 A We will initially invest it in short-term investments, but
22 we are also - will be looking at what additional work we can
23 do with that money.

24 Q Is there anything that Premera has wanted to do in the past
25 that it couldn't do because of capital constraints?

1 A I think we have - are always looking at what our priorities
2 are from the capital spending standpoint. And we go through
3 a very detailed process to assess what should we spend our
4 money on.

5 A specific example, ever since I have joined the company
6 in 1998, we have had a 20-year-old financial system that has
7 been held together by baling wire basically. We have put
8 off that expense because of not having the available
9 resources to do everything we wanted to do. We finally
10 kicked that project off this year to put in a new PeopleSoft
11 accounting suite.

12 Q And, in your opinion, Mr. Marquardt, who owns Premera
13 currently?

14 A No one owns Premera. We really believe that, you know, we
15 serve our members and our potential future members.

16 Q To whom is the board responsible?

17 A I think the board is responsible to itself.

18 Q Premera asserts that it is not a charity; is that correct?

19 A That's correct.

20 Q Is it Premera's intention to transfer 100 percent of the
21 value of the initial 100 percent of the stock to the
22 foundation shareholders?

23 A Yes. We intend to transfer 100 percent of the stock to
24 the - to the foundation.

25 Q And when you say, "100 percent of the stock," do you mean

1 100 percent of the value of Premera that is invested in that
2 stock via the stock?

3 A Well, I think you get into an interesting question of what
4 does value mean. I think if you look at the concept before
5 the IPO, there would be one definition of value, but if you
6 look at that at the IPO, you would have a different
7 definition of value that as you kind of open it up and allow
8 it to be fairly traded.

9 If you look at it three to six months later when the
10 stock is seasoned and hopefully we are performing and
11 executing on our strategy and plan, I think you look at it
12 as a different value. And hopefully each of those values is
13 stepping up as you move through that process.

14 Q Okay. So there is no one definition of value in your
15 opinion?

16 A Well, the true definition of value is what a willing buyer
17 and a willing seller negotiate to be the price. We don't
18 really have that in place here.

19 Q So I guess my question, then, is what is Premera's
20 intention?

21 A The intention is that 100 percent of the initial stock would
22 go to the foundations and that value would be determined
23 over the long run as that stock is moved into the public
24 markets. And we think that is the best realization of value
25 opportunity for the foundations.

1 Q Who runs the Blue Cross/Blue Shield Association?

2 A All of the member plans.

3 Q Of - and Premera is one of the members?

4 A That's correct.

5 Q What is the purpose of the restrictions in the license
6 agreement, do you know?

7 A I don't know what all - what the - the history is on that.

8 Q They are there to protect the name and the mark?

9 A Yes, they are.

10 Q And I believe - I don't know if it was Mr. Ancell or
11 Ms. Donigan who talked about your primary competitors in
12 this area - and she named several, Pacific, Aetna, CIGNA,
13 United - none of those carry the mark, do they?

14 A Well, I think you left out Regence Blue Shield --

15 Q Correct.

16 A -- which does carry the Blue Shield mark.

17 Q Right. But there are three strong competitors that don't
18 have the mark; correct?

19 A At least three that don't have the mark, yes.

20 Q Regarding the license agreement with the Blue Cross/Blue
21 Shield Association, if you don't comply with their license
22 agreement, then the Association can revoke your mark; is
23 that correct?

24 A That is a possibility.

25 Q Do you know - and you may not - if the Association views the

1 WellChoice transaction as kind of the high watermark?

2 A I think they view that as the most recent precedent. And
3 they have gone through a number of these transactions and I
4 think that's the best thinking at the time.

5 Q Do you know if they are unwilling to make any further
6 concessions in the future?

7 A That's my understanding.

8 Q Why - do you know why?

9 A I don't know the - all the whys behind that, other than I
10 think it has been a long process that they have gone through
11 in all these negotiations and I think they feel they have
12 got to the state of the art.

13 Q Is there anything in the licensing agreement that would make
14 the WellChoice deal the standard for applicable conditions?

15 A I don't believe there is anything in the licensing
16 agreement.

17 Q Has Premera agreed in this transaction to all the terms that
18 were agreed in the WellChoice deal?

19 A No, we have not.

20 Q Why have you selected some yet not selected others?

21 A The one that I can remember off the top of my head is the
22 voting trust arrangement where if the mark would go away, we
23 would lose the voting trust arrangement. We believe we are
24 in a very different situation than WellChoice and that we
25 have to compete with Regence Blue Shield.

1 Even though we think it is remote that we would lose the
2 mark, you never know what could happen, that for whatever
3 reason that mark could go to Regence and we would lose that.
4 We think to protect the subscribers, you want a board that
5 has experience in running an insurance company, not in
6 running a foundation.

7 Q Premera has projected to grow without the conversion 15
8 percent, is that correct, per year?

9 A We projected our top-line and our net income 15 percent year
10 over year.

11 Q And that's without the conversion?

12 A That's without the conversion.

13 Q There are certain things that impact the RBC and certain
14 things that don't impact the RBC, as I understand it. Would
15 - for instance, hiring or firing personnel, does that impact
16 the RBC?

17 A Only if you reduce your admin costs and reduce your expense,
18 so a single hiring or firing would not have any impact.

19 Q But if you hired, say, 50 more employees, would that impact
20 the RBC?

21 A It would increase your expense rate and reduce the amount of
22 net income and reduce the amount of statutory capital we
23 would have, so, yes, it would have an effect.

24 Q Thanks.

25 How about when you upgrade your technology systems, does

1 that directly impact the RBC?

2 A It does because it is an investment in - in technology that
3 would be a not admitted asset under statutory accounting.

4 Q You talked about converting to invest in infrastructure,
5 product and services. Can you define what you mean by
6 "infrastructure"?

7 A Sure. We have talked a little bit about Dimensions. Think
8 of Dimensions as the foundation of the house. We have got
9 the foundation. We have got the core system to run all of
10 our membership through all of our eligibility, all of our
11 claims through.

12 Now, we have got to have all the connectivity. We have
13 got to put all the finishing touches on all the rooms. So
14 we got to make sure that we have the connectivity to the
15 providers. And I think Mr. Smit talked a little bit about
16 this, to be able to go online with the providers to decide
17 when a person comes in, are they eligible, what their
18 benefit structure is, how to adjudicate the claim. Those
19 types of connectivities with members, with groups, with
20 brokers are all part of the additional things that we need
21 to continue to do.

22 We also need to finish out the basement. We need to
23 make sure that basement is running - the foun- - there is no
24 leaks in the foundation. So there is a lot of work on
25 service enhancements and how we do business that will come

1 in behind the core system as the core system goes up.

2 We had our old Legacy system in place for 20 years. So
3 there is a lot of refinements that went in in that 20-year
4 period to get that working as efficient as it could. It
5 will take some period of time and some level of investment
6 to get the Dimensions platform to be working where we want
7 to it be.

8 Q Now, when you started out with the Dimensions to enhance -
9 to create this new product line and service itself, did you
10 not have a budget for follow-along enhancement?

11 A Yes, we do. It is part of additional capital needs that we
12 are going to spend. So there is capital in our Form A
13 filing. We expect to spend 20 to 30 million a year. But it
14 is part of that whole mix of things that we set priorities
15 around.

16 As Mr. Smit told - told you earlier, we have a whole
17 list of projects that we go through extensive analysis on as
18 to which of the priority things that we should be doing with
19 the capital that we have. If we have more capital, we will
20 be able to do more things on that list.

21 Q Okay. So it is a trade-off basically on what you do first
22 and what you do second --

23 A Yeah.

24 Q -- based on your capital?

25 A There is a lot of business analysis that goes into, say, if

1 I have this much capital, this is what I can do. If I have
2 this much capital plus another 20, 30 million, this is what
3 I can do.

4 Q And it is going to be that way regardless of the conversion
5 or not?

6 A Yeah, it will be that way, but with the conversion, we will
7 have the ability to fund more of those projects and to do
8 more of those things quicker. And we think it will allow us
9 to be more successful in the long run and allow us to get to
10 a point where we can continue to provide better service to
11 our subscribers and our members and to continue to attract
12 new members.

13 Q Do you have an estimated cost of these enhancements?

14 A It is part of the whole project pool. I don't have an exact
15 number for you.

16 Q How about timing of implementation?

17 A I think this is over the next three to five to more years.

18 Q What will you --

19 A And it is a never ending process.

20 Q Yeah. Okay.

21 A So that's why I'm a little - what is the next newest thing
22 that will come on? I mean, five years ago we wouldn't have
23 anticipated the amount of Internet connectivity that we have
24 today.

25 Q I understand that you are going to increase your margins

1 through administrative efficiencies; is that correct?

2 A That's our intent.

3 Q Can you explain how you intend to get there?

4 A Yeah, one of the things that we have going now is that with
5 the Dimensions system up, we have roughly 500,000, 600,000
6 of our members on that system. We also have in play five
7 other systems, so we are still running multiple platforms
8 through Premera.

9 As we get through the complete sellover of business to
10 Dimensions, we'll be down to one system. We have asked each
11 of our departments to look at what is life like after
12 Dimensions. After we get to one platform, what does that do
13 from an impact on your department? Do you get better
14 information? Are you able to be more efficient because now
15 you are not trying to run off of five different systems?
16 And the answer is yes. So we are in the process of putting
17 together and implementing those detailed plans.

18 Q So once you make the switch to just being Dimensions, that
19 will take away all the old systems that you had to sort of
20 piece together?

21 A We will shut down all the old systems, so those will go
22 away. We will have everybody up on one platform that is an
23 easier-to-use platform. We hope to see continued
24 efficiencies come out of that process along with continuing
25 investments in it to get to the kind of better efficient

1 world.

2 Q How has the company changed from the time you started to
3 today as far as efficiencies?

4 A Well, I think the company has gone from what we historically
5 referred to as kind of a turnaround state, where it was very
6 hands-on, you know, we got to fix it. We were in a very
7 difficult spot. We were on early warning with the
8 Association back when I started. We were losing money from
9 operations. And so we went through this period, you know,
10 basically hands-on, making lots of decisions on the
11 executive management level.

12 We went through the next stage, after we got through the
13 turnaround, of planning what Dimensions would be, what the
14 strategy would be. And Dimensions, it is more than a
15 system. It is really a transformation of how we do
16 business. And you also heard that we transformed how we did
17 care management, moving away from kind of being the - the
18 stopping point to being the care facilitator on care
19 management.

20 And those types of things are ongoing evolutions on how
21 the company has continued to the change to focus on our
22 customers and stakeholders and really focus on building the
23 company from the top down. So we continue to drive
24 decisions down through the company and build the management
25 structure of the company. So we are a much different

1 company than, you know, five, six years ago when I joined
2 it.

3 Q How much has Premera spent so far on this conversion?

4 A I think the latest number is around 31 million dollars.

5 Q Does that impact the RBC?

6 A Yes.

7 Q When did Premera first present the conversion issues to the
8 Blue Cross/Blue Shield Association?

9 A I'm not sure which - which issues are you - are you talking
10 about the unresolved points?

11 Q No, the topic of conversion to start with.

12 A I believe it was shortly after we announced in May of 2002 -
13 I think Mr. Barlow testified that he had talked to the
14 president of the association, Mr. Sabota (phonetic), that we
15 intended to move forward with this.

16 Q Did Premera send a copy of the original Form A application
17 into the Blue Cross/Blue Shield Association before it was
18 filed with the Commissioner?

19 A I don't know that. I don't think we did before it was
20 filed, but I think we might have sent it after, but I'm just
21 not sure.

22 Q Okay. Do you know if it got any comments then?

23 A I don't know.

24 Q Okay. Who would know that?

25 A Legal counsel.

1 Q Did you send copies of the amendments of the Form A to the
2 Association?

3 A I do know we did that.

4 Q Did you get any comments on those?

5 A Yes, we did.

6 Q What were they?

7 A We were - they were to the points that we talked about
8 earlier.

9 Q Okay. Do you think it possible that it may be necessary to
10 modify or amend the articles or bylaws of the foundation in
11 order to obtain IRS recognition of its tax exemption?

12 A It is my understanding we don't believe that is - that it is
13 going to be necessary --

14 Q Okay.

15 A -- but are in the process of filing for a ruling on that.

16 Q Is Premera contemplating a merger or sale within the next
17 five years?

18 A No, we are not.

19 Q How about the next 10 years?

20 A No, we are not. You heard testimony from Ms. Jewell that
21 the board had not contemplated that.

22 Q In your opinion, what is the value of being locally owned?

23 A I think there is a unique market. I think healthcare is
24 delivered in the region. I think having local people in the
25 region is an important component and I think we can be a

1 very successful regional player.

2 Q "Region" meaning what? Washington State? The Pacific
3 Northwest?

4 A Well, I think it is the Northwest, but I think we also have
5 to look at how do we continue to grow the business? How do
6 we continue to grow our membership to spread our costs? It
7 is an important criteria to have a continue growing base to
8 continue to spread costs to not only drive efficiencies, but
9 to be competitive in the market.

10 Q You currently have a support business in Oregon, right?

11 A We have a nonBlue business, LifeWise of Oregon, that
12 operates in Oregon.

13 Q And in Arizona; correct?

14 A And we have a start-up called LifeWise of Arizona that is
15 starting in Arizona.

16 Q And how are they - are they operating well?

17 A Well, the Oregon business is doing very well. Arizona is a
18 start-up, so it is a little too early to tell.

19 Q Did you buy that business down there?

20 A No, it was, you know, started from the ground up.

21 Q Is every product line profitable at Premera?

22 A We really look at our business as a portfolio of businesses.
23 We have - we are insuring a million-and-a-half members and
24 we are trying to spread risks over a number of different
25 businesses and a number of different markets, so not every

1 line is profitable.

2 Q Do other lines, then, subsidize the nonprofitable lines?

3 A You know, I really wouldn't look at it as subsidize. We
4 look at it in saying does every line cover the variable
5 costs of doing business in that? And the answer to that is
6 yes.

7 Now, we do have a pool of fixed overhead that we want to
8 get contribution from every line. Some lines contribute
9 more. Some lines do better one year than the next year.
10 This is a very difficult business to try and predict what
11 healthcare cost trends are and what rating and pricing
12 should be. And we have a lot of discipline around that, but
13 - you know, no slam to our actuaries, but we are not going
14 to get that right every time.

15 So we think were very disciplined about it, but it will
16 vary from year to year. And the trends that we try to set
17 will vary from year to year.

18 Q I understand that you have a line of business that are
19 administrative services contracts; is that correct?

20 A Yes, that's correct.

21 Q And they have not been profitable in the last few years,
22 have they?

23 A Well, they haven't been profitable from a fully allocated
24 cost standpoint. From the covering of our variable costs
25 standpoint, they have been.

1 Q Okay. But in your bottom line, it is a negative.

2 Number, isn't it?

3 A It's a negative number.

4 Q Okay.

5 A Yes, it is.

6 Q So how does that - you just said that they are not
7 profitable in one way, but they are in another.

8 A Yeah. Yeah, let me --

9 Q Can you dumb that down for me a little bit?

10 A Yeah. Yeah, I think I can. We look at this business - we
11 look at what is the market rate for this business and what
12 do we have to price our business at to compete in that
13 market. So we know what the market is to compete with the
14 Uniteds, the Aetnas, the CIGNAs, the Regences, et cetera.

15 And we look at can we deliver at that price. And in
16 making that decision, we look and say what are the direct
17 costs of servicing that business, so how many customer
18 service reps will I need to have, how many claims processes
19 will I need to have, how many support - sales support people
20 will I need have. And that we view as our direct variable
21 cost of service in that business.

22 And our intent is to price the ASC business, a large
23 group business, to cover that direct cost and get
24 contribution to overhead and that over the long-term, move
25 it to kind of a break-even or better profit margin. So as

1 we get more efficient at delivering business and as we get
2 more coverage of our fixed overhead, we can move that
3 business up from an operating loss to at least an operating
4 break-even.

5 Q So initially you price to be competitive, which might not
6 cover all your costs, but over time you learn how to do it
7 more efficiently and your profits increase?

8 A That's the plan as we get to the more administrative
9 efficient and we get to - continuing to price the business.
10 A large account, like Washington Mutual, really doesn't like
11 to change. I mean, they will change their business once
12 every 10 years unless there is a big problem. So there is a
13 long-term track opportunity with these clients to continue
14 to service them and provide - provide service for them.

15 Q And how are the losses absorbed by the company?

16 A Well, we have the direct costs covered. We have a pool of
17 fixed costs that have to be covered by a number of different
18 sources, so those fixed costs don't go away if we didn't
19 have these business. As long as we are getting a
20 contribution to that fixed cost, it is still a good business
21 decision for us.

22 Q Okay. To your knowledge, did the board reject the
23 possibility of selling Premera to another company such as
24 Anthem?

25 A To my knowledge, there has never been any kind of proposal

1 like that.

2 Q You haven't received the final tax opinions yet, have you?

3 A We have actually submitted the final opinion in - I think it
4 was P-64.

5 Q Okay. Once Premera is a publicly traded company, assuming
6 that the conversion goes through, won't it have to eliminate
7 products or services that are not profitable?

8 A You know, we look at our business now and one of our
9 objectives is to focus on profitable growth, so we look at
10 any line of business and say can it cover the direct costs
11 that applies to it or what is the plan to fix that? And if
12 we get to a situation where we can't do that, we will exit
13 that business.

14 We made a decision not to renew the Public Employee
15 Benefit, the PEBP business, this year because the rate
16 structure was unacceptable. We were going to lose millions
17 of dollars on that business if we were going to renew at the
18 rates the state wanted to. So we will make those calls
19 whether a conversion happens or doesn't happen.

20 Q Okay. The first foundation board, who will appoint that?

21 A We have appointed it just for the purpose of being able to
22 put board members on the application for the text.

23 Q And how did you select those members?

24 A We actually selected internal Premera people rather than
25 trying to recruit people from the outside just for

1 expediency.

2 Q Then the second board is appointed by the Attorney General?

3 A The second board would be appointed by the Attorney General
4 once the conversion was approved.

5 Q And then you spoke about a third board.

6 A The third board is really an extension of the second board.

7 We would expect that second board would be a smaller,
8 four-to-five-person group that would deal with the financial
9 matters around the IPO. And then as the board got into more
10 of functioning as a foundation, then additional appointees
11 would happen to drive the grant-making side of the house.

12 Q Would you allow another entity, say the AG, to appoint the
13 initial board?

14 A I think we probably would have, but I don't think that was
15 an option and we kind of said we actually have appointed it
16 in preparing the documents for filing.

17 Q So those are the folks that will be signing for the
18 foundation?

19 A Will be signing just for the tax application for the
20 foundation and then this will go away. We really didn't
21 think it was an attractive position for anybody to be in,
22 that would attract too many people that would go on a board
23 that was short-term for filing tax statements.

24 Q The foundation - I guess the bylaws requires or sets out who
25 can become a member of the board of directors of the

1 foundation; is that correct?

2 A That's correct.

3 Q And it sets out a laundry list of restrictions; is that
4 correct?

5 A I believe that's correct.

6 Q Who designed those restrictions?

7 A I don't know specifically who. I'm sure the legal team
8 worked on that.

9 Q Why are there so many restrictions for the foundation board?

10 A I can't speak to that.

11 Q Do you know who could?

12 A I would think our legal experts.

13 Q Okay.

14 A Potentially Mr. Steel.

15 Q Okay. Is Premera's growth over the next five years or so
16 going to be predominantly in the administrative services
17 area - contract area?

18 A No, we believe it will be over all our business. We think
19 we can grow our insured business, you know, roughly four
20 percent a year and we can maybe grow our administrative
21 self-funded business maybe a little higher.

22 I think we are seeing a phenomena in the business where
23 people are looking at should I be insured or should I be
24 self-funded, so that may shift over time. So that's kind of
25 an ongoing shift of people making decisions on how they want

1 to fund their healthcare.

2 Q Is that growth going to be the same mind-set whether you
3 convert or not?

4 A Yeah, I think it is. I think we have probably a higher
5 potential of achieving those targets if we convert, because
6 I think we will be better positioned to attract new members.

7 Q Now --

8 A So I think it is maybe not a degree of what our targets will
9 be, but what our possibility of success will be.

10 Q Now, please explain this to me if I'm wrong, for an
11 administrative services contract, Premera doesn't assume any
12 risk; is that true?

13 A That's correct.

14 MS. deLEON: I have no further questions. Thank
15 you.

16 JUDGE FINKLE: About how long do you think you will
17 be?

18 MR. MADDEN: Ten to 15 minutes, Your Honor.

19 JUDGE FINKLE: What is the stance on - how long on
20 redirect?

21 MR. MITCHELL: Probably five.

22 JUDGE FINKLE: We will go ahead for a bit anyway.

23 MR. MADDEN: Okay.

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CROSS-EXAMINATION

BY MR. MADDEN:

Q Good afternoon, Mr. Marquardt.

A Good afternoon, Mr. Madden.

Q Premera has an operating margin of slightly less than two percent; is that right?

A That's correct.

Q And Premera hopes and intends that if it is allowed to convert, that it will improve that margin; is that correct?

A That's correct.

Q Because that margin will have to be available to satisfy whatever expectations the shareholders of New Premera may have; correct?

A Well, I think that's maybe a little misstatement. I think the expectations of a public company are - and, you know, where we have kind of set the bar, based on advice from a number of people, is that if you can grow your net income 15 percent year over year, you look like a pretty successful public company. And our intent is to grow that income 15 percent year over year.

And, now, can you do that without greatly increasing your margins? Well, yes, you can, because if grow top-line at a similar amount, you don't really have to grow your

1 margins significantly. So the metric that we are looking at
2 is not really what the margin is, but what the net income
3 level is and what the growth of that is.

4 Q Am I - am I correct that Premera's general and
5 administrative expense ratio is about 14 - 14 percent?

6 A Oh, you know, I don't have it right on the tip of my tongue,
7 but that's probably in the ballpark.

8 Q Do you know what the average general administrative expense
9 ratio is for Blue plans nationally?

10 A In that same neighborhood.

11 Q Okay. How about for - do you know what it is for nonprofit
12 Blues?

13 A I don't have a separate distinction between - you know, I
14 haven't looked at splitting up not-for-profit Blues versus
15 for-profit Blues.

16 Q How about for Regence?

17 A It's in that same general ballpark.

18 Q Okay. Do you believe that Regence strives to minimize its
19 general and administrative expenses?

20 A I really don't know what Regence strives to do.

21 Q Okay. Premera also has a medical loss ratio of about 84
22 percent; is that right?

23 A That's correct.

24 Q And that means that 84 cents of every premium dollar that
25 you collect is paid out for the costs of care and related

1 expenses?

2 A That's correct.

3 Q Let me ask you some questions about the tax opinion that is
4 admitted as Premera's Exhibit 64. Do you still have that in
5 front of you?

6 A Yes, I do.

7 Q That document is dated April 26th, 2004; is that correct?

8 A That's correct.

9 Q And is this document what - what we have called heretofore
10 called the short form tax opinion?

11 A Yes, it is.

12 Q And the document that is admitted as Premera Exhibit 64 is
13 an update of an earlier short form opinion by Ernst & Young;
14 is that also correct?

15 A This is the final version of the tax opinion --

16 Q Okay.

17 A -- based on information as of now.

18 JUDGE FINKLE: If you want us to see it, we have got
19 a blank here and --

20 MS. SUREAU: All three. We have blanks.

21 MR. MADDEN: I know it came through to everyone
22 blank and then Premera handed it in late, I think. I'm not
23 saying that pejoratively. But I had assumed it had been
24 updated in the books by now.

25 MR. MITCHELL: I am advised that this document which

1 was due on April - one week before the hearing was filed as
2 a PDF file to be inserted in the book the same day that the
3 books came down.

4 MS. BEUSCH: We don't have . . .

5 MS. SUREAU: What date was that, Rob?

6 MR. MITCHELL: What was the date?

7 Two weeks ago today.

8 JUDGE FINKLE: You can supplement later - if you
9 want us to see it, though --

10 MR. MADDEN: What I was going to say is I'm quite
11 willing to hand up - and let me make sure it is unmarked - a
12 copy from my exhibit book. And if there is a way I can get
13 it back at some point --

14 JUDGE FINKLE: Why don't we take a recess and you
15 can get a chance to copy it. Fifteen minutes.

16
17 (Brief recess.)
18

19 Q (BY MR. MADDEN) Mr. Marquardt, I believe while we were in
20 the process of making sure the Commissioner had a copy of
21 Exhibit P-64, I was asking the question whether there was an
22 earlier draft of the short form opinion and I believe you
23 indicated that there was; correct?

24 A That's correct.

25 Q And the - the earlier draft short form opinion reached the

1 same conclusions regarding the probable tax treatment of the
2 proposed transaction; is that correct?

3 A I think it is similar. I think there might have been some
4 wording changes, because the structure change, I think there
5 was some things that had impact in the opinion.

6 Q The final short form tax opinion by Ernst & Young reaches
7 the conclusion that the conversion will constitute a
8 tax-free reorganization under the Internal Revenue Code; is
9 that correct?

10 A That's correct.

11 Q Now, the draft short form opinion was provided to the OIC
12 staff and its consultants, was it not?

13 A That's correct.

14 Q Okay. And is it also correct that there was a draft long
15 form opinion by Ernst & Young that contained, as the name
16 implies, a lengthier, more detailed analysis of the tax
17 issues presented by the proposed transaction?

18 A That's also correct.

19 Q Okay. Was that long form opinion also provided to the OIC
20 staff and its consultants?

21 A Ernst & Young has come to the conclusion that they don't
22 need to issue a long form opinion. There is a technical
23 memorandum that supports the short form opinion that is
24 being finalized through their final, kind of, peer review.

25 Q I think you may have anticipated one of my next questions,

1 but the question I was asking was was the draft long form
2 opinion provided to the OIC staff and its consultants?

3 A Yes, it was.

4 Q Now, this technical memorandum that you mentioned, is that
5 in the record anywhere that you know of?

6 A No, it is not.

7 Q Now, are you aware that the staff's tax consultants from
8 PricewaterhouseCoopers did not undertake an independent
9 analysis of the tax questions with which Ernst & Young
10 dealt?

11 A That's my understanding.

12 Q And instead you are aware that PricewaterhouseCoopers has
13 advised the Commissioner that Premera's reliance on the
14 Ernst & Young opinion is reasonable?

15 A I believe that's correct.

16 Q Okay, but the Ernst & Young opinion that they were - that
17 PricewaterhouseCoopers were opining on was the earlier draft
18 opinion and supporting draft long form opinion; is that not
19 also correct?

20 A I believe that is correct.

21 Q Okay. And are you also aware that PricewaterhouseCoopers
22 indicated that if the final Ernst & Young opinion indicated
23 any less certainty than the will standard, will be tax-free,
24 that the Commissioner could - should consider whether that
25 was an appropriate level of assurance given the magnitude or

1 significance of the adverse tax consequences facing Premera;
2 correct?

3 A I believe that's correct.

4 Q A long way - a windy way of saying it is an important issue
5 for the company whether this transaction will be treated as
6 tax-free; correct?

7 A Well, I think it is an issue. I'm not sure I would
8 characterize it as - as a critical issue, but it is an issue
9 and we would obviously like to see a tax-free reorg happen.

10 Q Upon the several transactions that constitute a part of this
11 conversion is Premera's transfer of New Premera stock to the
12 foundations; correct?

13 A That's correct.

14 Q And Ernst & Young has opined, to your understanding, that
15 that transaction or transactions will constitute part of the
16 tax-free reorganization; correct?

17 A Well, they will be transferred on a tax-free basis, yes.

18 Q Let me call your attention specifically to Page 2 of Exhibit
19 64, the - at the top of the page the clause that begins
20 after the first colon, it reads, "Premera will dissolve
21 pursuant to RCW 24.06 and distribute all of its assets
22 consisting solely of the stock of New Premera to its sole
23 members, the Washington foundation and/or the Alaska
24 foundation, (selectively called the conversion)." And that
25 last part is in parens.

1 Has Premera inquired of Ernst & Young whether the fact
2 that I - or the statement that I have just read is material
3 to its tax opinion?

4 A Well, these are the facts of the transaction and Ernst &
5 Young has given their opinion that based on these facts they
6 will give to a will opinion.

7 Q Well, the reason I ask the question, Mr. Marquardt, is that
8 when Ms. deLeon inquired of you whether this conversion
9 transaction would, in the view of Premera, result in the
10 transfer of the full asset value of the company to the
11 foundations, you gave what seems to me to be kind of an
12 equivocal answer. In other words, you were saying it
13 depends on the timing and the circumstances and there are -
14 it is a nuanced question.

15 MR. MITCHELL: Object- --

16 Q (BY MR. MADDEN) Is that fair?

17 MR. MITCHELL: Object to the question as
18 argumentative.

19 JUDGE FINKLE: Sustained.

20 Q (BY MR. MADDEN) Well, let me try to get your testimony
21 framed up for the Commissioner. Is it your view as the CFO
22 of Premera that whether or not the transfer of New Premera
23 stock to the foundations results in the transfer of the full
24 asset value is a nuanced question?

25 A I'm not sure what you mean by "nuanced question."

1 Q Meaning it depends on the circumstances and the timing
2 whether the foundations will receive the full value of New
3 Premera.

4 A No, I don't think that's true at all. I think the transfer
5 of 100 percent of the stock is the dissolution - it falls
6 into the category of dissolution of the old company into -
7 into the foundations. And the question of value may be a
8 nuance that depends on what happens to the public markets
9 to - as the foundation liquidates that value. But 100
10 percent of the stock is the extent of the liquidation of the
11 old company.

12 Q All right. Let me ask you - I opened up in front of you
13 another notebook and I don't know if you can reach it
14 easily. If not, I will come up and hand it to you.

15 A Yeah, I got it.

16 Q Okay. If you would turn to Intervenor's Exhibit 4?

17 A You had it opened to that section.

18 Q Sometimes I have to make a record. I'm going to wait for
19 the Commissioner and his staff to get with me.

20 Intervenor's Exhibit 4 is a copy of the Ernst & Young
21 draft long form opinion that we discussed earlier, is it
22 not?

23 A Yes, it is.

24 Q Did Premera provide the information upon which the Ernst &
25 Young long form opinion is based?

1 A Premera did not provide the information on this document, on
2 the draft document that is in front of me. This was done by
3 Ernst & Young without consultation from Premera. So this
4 was developed by Ernst & Young staff without review by
5 Premera.

6 Q Okay. This document is dated February 13th, 2003, is it
7 not?

8 A That's correct.

9 Q And when would - when approximately was it provided to the
10 OIC staff and consultants?

11 A I believe shortly thereafter. I'm not sure of the exact
12 date.

13 Q Okay. Did Premera review the document before it turned it
14 over to the OIC?

15 A We reviewed the opinion and the conclusions. And the
16 conclusions were consistent with - with what our
17 interpretation of the tax reorg should be. We did not
18 review the representations that were made in this letter.

19 Q Has Premera advised the OIC staff and consultants that it
20 disagrees with any of the representations contained in the
21 draft long form opinion?

22 A Well, I think if you read at the bottom of this opinion that
23 we have not agreed to the representations set forth here in.
24 This was the document that was filed, so it we never said
25 that we agreed to these representations.

1 Q My question was actually the opposite, Mr. Marquardt. Has
2 Premera ever told the consultants that it does not agree
3 with any of the representations contained in I-4?

4 MR. MITCHELL: Object to the form of the question as
5 asked and answered.

6 JUDGE FINKLE: Overruled.

7 A I'm not so sure that that specific direction came up in
8 discussions, so I can't - I can't say yes or no to it.

9 Q (BY MR. MADDEN) Well, let's - I'm sorry. Let's frame this
10 up. Premera certainly knew that PricewaterhouseCoopers was
11 reviewing the potential tax treatment of the transaction;
12 correct?

13 A Correct.

14 Q And it knew, as you said, that PricewaterhouseCoopers was
15 reviewing the work that had been done by Ernst & Young?

16 A Correct.

17 Q Okay. And over the year or plus that the Ernst & Young
18 draft long form opinion has been in circulation, Premera
19 certainly had a chance to read it in detail; correct?

20 A I don't know. We furnished over 40,000 pages of documents
21 to the OIC, so I'm not sure that, you know, this fell at the
22 top of the list.

23 Q Okay. Have you read this document before?

24 A I have, but not in conjunction with the OIC filing.

25 Q And so in that - in that time frame, Premera has never seen

1 fit to call to the attention of the OIC staff that it
2 believed that some of the representations made in the draft
3 long form opinion were incorrect?

4 A Well, you know, I hate to kind of tell you the same answer,
5 but on the document it says we have not agreed to these
6 representations and the intent here always was that once the
7 transaction became closer to final, we would look at what
8 the facts and circumstances are, make sure that Ernst &
9 Young understood what those circumstances are and represent
10 those facts and circumstances, which is what is in the P-64
11 document.

12 Q So, Mr. Marquardt, so that record is clear, the only comment
13 that Premera has made on the accuracy of the representations
14 contained in the Ernst & Young long form opinion is
15 contained in the legend that appears at the bottom of each
16 page of that document?

17 A I can't speak to the discussions that were had with PwC and
18 all the hours that we spent going through this with them as
19 to, you know, did we get into this level of detail. I
20 personally did not.

21 Q Okay. So, as far as you know, that kind of correction has
22 not been furnished to the PwC consultants?

23 A Again, I wouldn't call it correction. I would say that we
24 have not reviewed this document in detail or agreed to it.

25 Q Let me go in the other direction. Has Premera informed

1 Ernst & Young that it believes any of the facts and
2 circumstances recited in the long form opinion are
3 incorrect?

4 A In this draft opinion?

5 Q Correct.

6 A I think the representations that we have made in the P-64 is
7 - is the appropriate understanding of what the transaction
8 is. The transaction changed subsequent to this draft
9 document.

10 Q Well, my question was a little different again.

11 Have you informed PricewaterhouseCoopers that you
12 believe any of the facts and circumstances recited in the
13 long form opinion are incorrect?

14 A I personally have not.

15 Q And, to your knowledge, has anyone on behalf of the company?

16 A Not to my knowledge.

17 Q All right.

18 MR. MADDEN: We would offer I-4 at this time, Your
19 Honor.

20 MR. MITCHELL: We would object, Your Honor, on
21 multiple grounds including that the document is authored by
22 someone who is not before us to testify as to how it was
23 created. It does not reflect any representations by
24 Premera. It bears on its face a legend that they have not
25 agreed to these things.

1 The witness's testimony is that they were not reviewed.
2 We think that it is both hearsay and completely unreliable.
3 And if there is any question about the representations that
4 underlie the opinion that is filed in this case, they are in
5 Exhibit P-64.

6 MR. MADDEN: This was furnished to the Staff and to
7 PricewaterhouseCoopers with the knowledge, if not the
8 intent, that the Staff and the - and PricewaterhouseCoopers
9 would rely on it.

10 What you will see has happened here is this opinion,
11 which presents the detailed basis for the conclusion that
12 this will be a tax-free reorganization, is based on facts
13 that now contradict Premera's legal position in this case
14 and instead what they have done is presented you with a
15 sanitized final version that does not go into the detailed
16 analysis that you see here. And apparently they have also
17 prepared this technical memorandum that they have not seen
18 fit to present into the record.

19 And so the only thing that we have to allow the
20 Commissioner to evaluate the voracity of Premera's analysis,
21 and indeed the PricewaterhouseCoopers' analysis, is this
22 long form opinion. And it is clearly the kind of thing upon
23 which reasonable persons would rely. And so it took me 15
24 minutes to get Mr. Marquardt to admit that even though they
25 have had it for a year, they have not seen fit to inform

1 either the Commissioner or the consultants that anything in
2 it is inaccurate.

3 I think in those circumstances I'm entitled to show the
4 details of the document so that the Commissioner can be
5 fully informed about the basis for the Ernst & Young
6 conclusion that this will be a tax-free transaction.

7 MR. MITCHELL: If I may be heard. Counsel has tried
8 to argue about what his interpretation of this document is.
9 The reality is that the only tax opinion that is in the case
10 is the one that is Exhibit P-64. The representations that
11 underlie it are incorporated into P-64.

12 There has never been a representation by Premera that is
13 reflected in this document and Premera has never represented
14 to anybody, including the OIC Staff's consultants, that
15 these representations are its own or that they are accurate.
16 Indeed, every page of this document bears a legend to the
17 contrary.

18 JUDGE FINKLE: Admitted. It goes to the weight.

19 Go ahead, please.

20 Q (BY MR. MADDEN) Mr. Marquardt, could you turn to Page 3 of
21 the long form draft opinion?

22 A (Complying.)

23 Q If I can direct your attention to the bottom of the - the
24 last clause of the very lengthy opening paragraph that is
25 headed "Introduction" which states, "Premera will dissolve

1 pursuant to the RCW and distribute all of its assets
2 consisting solely of the stock of New Premera to the
3 foundation, the transaction."

4 If we were to amend "the foundation" to "the
5 foundations," that conclusion - or that statement is
6 identical to what is found in the Premera Exhibit 64, is it
7 not?

8 A I would have to look at 64, too.

9 Q Sure.

10 A Do you know where it was on 64?

11 Q I did.

12 It is on Page 2 at the top of the page. It appears
13 after the first colon - semicolon.

14 A I think the difference is it also speaks to its sole
15 members, the Washington foundation and the Alaska
16 foundation.

17 Q And that reflects the change in the Form A from September of
18 '03 - or September of '02 to February '04, does it not?

19 A It reflects the two foundations, but it also has in here the
20 sole number of - well, I'm not sure that has any relativity
21 or not.

22 Q All right. Let me ask you to turn to Page 14 of Exhibit
23 I-4, the long form opinion .

24 A (Complying.)

25 Q Directing your attention to the middle of the page, the

1 paragraph that is numbered Roman Numeral 6A4. Have you
2 located that?

3 A I'm sorry, on Page 14?

4 Q Yes.

5 A I don't have a 6A4.

6 Q Okay. Do you see a heading "Representations Made By
7 Premera"?

8 A Yes.

9 Q Okay. Fourth paragraph numbered 4 under that?

10 A Yes.

11 Q All right. It is late in the day. It's okay.

12 That paragraph states that "The fair market value of the
13 New Premera stock and other considerations to be received by
14 the foundation will be approximately equal to the fair
15 market value of the Premera membership interest immediately
16 before the transactions are consummated."

17 If we were to amend that statement to say "foundations,"
18 plural, would Premera agree with that representation?

19 A I don't believe that that is the representation that we made
20 in - in the P-64 document.

21 Q All right. Let me ask you to turn to Page 59 of Exhibit
22 I-4.

23 A (Complying.)

24 Okay.

25 Q Let me direct your attention to the short paragraph in the

1 middle of the page that begins, "Premera offers." Do you
2 see the statement in that paragraph, "Premera's purpose is
3 to conduct activities that are desirable for the welfare of
4 the community, i.e. communities of Washington and Alaska,
5 served by the Premera group"?

6 A Yes.

7 Q Does Premera agree with that representation?

8 A I do not believe that was a representation that we made in
9 P-64.

10 Q Do you disagree with it?

11 A I'm not sure that I understand it.

12 Q All right. Well, let's let the document speak for itself.

13 Could you turn to Exhibit I-6, Mr. Marquardt?

14 A (Complying.)

15 Yes.

16 Q Do you recognize Exhibit I-6 as a copy of the Articles of
17 Incorporation of the Washington Hospital Service
18 Association?

19 A I am afraid to admit that I do.

20 Q And that is the original corporate entity, the predecessor
21 to Premera Blue Cross; correct?

22 A Yes, it is.

23 Q All right. And directing your attention to what is headed
24 "Article 2" of Exhibit I-6, headed "Purpose," does that
25 contain a statement of corporate purpose for the - the

1 original Blue Cross entity that is now Premera Blue Cross?

2 A I believe it does.

3 MR. MADDEN: Offer I-6, Your Honor.

4 MR. MITCHELL: No objection.

5 MS. deLEON: No objection.

6 JUDGE FINKLE: Admitted.

7 Q (BY MR. MADDEN) The statement of corporate purpose in the
8 original articles, which are, by the way, dated 1945,
9 includes a statement that "The purpose is to promote the
10 general and social welfare of such persons as may become
11 subscribers of the plan and to do all things necessary
12 proper and convenient for the purpose of promoting,
13 establishing and operating such nonprofit hospital service
14 plan;" is that correct?

15 A It has been a little while since I read this one, so let me
16 just make sure.

17 That's correct.

18 Q Do you know if Ernst & Young reviewed this document in
19 connection with its work?

20 A I don't know.

21 Q Let me ask you to take a look at the next Exhibit, I-7. Do
22 you recognize that document as a copy of the Articles of
23 Incorporation for the Medical Service Corporation of
24 Spokane?

25 MR. MITCHELL: Did you mean to say Spokane County,

1 Counsel?

2 MR. MADDEN: Thank you.

3 A Yes.

4 Q (BY MR. MADDEN) And do you recognize these as the original
5 articles of the Medical Service Corporation that was later
6 merged into Premera Blue Cross?

7 A I was trying to find a date on it. I didn't see that on
8 there. Oh, here it is.

9 Q I believe it is 1933.

10 A I believe that's correct.

11 MR. MADDEN: Offer I-7, Your Honor.

12 MR. MITCHELL: No objection.

13 MS. deLEON: No objection.

14 JUDGE FINKLE: Admitted.

15 Q (BY MR. MADDEN) On Page 2 of I-7, Article 3 contains a
16 statement of the corporate purpose of the Medical Service
17 Corporation, does it not?

18 A Yes, it does.

19 Q Let's turn to Exhibit I-9, if you would, sir. I'm sorry,
20 I-8. Excuse me.

21 A (Complying.)

22 Q Do you recognize Exhibit I-8 as the Amended Articles of
23 Incorporation of the Medical Service Corporation?

24 A Yes.

25 Q And, again, this is the same entity that was later merged

1 into Premera Blue Cross?

2 A Yes, it is.

3 MR. MADDEN: Offer I-8, Your Honor.

4 MR. MITCHELL: No objection.

5 MS. deLEON: No objection.

6 JUDGE FINKLE: Admitted.

7 Q (BY MR. MADDEN) Mr. Marquardt, on the second page of I-8
8 under Article 3, there is also a statement of corporate
9 purpose, is there not?

10 A Yes, there is.

11 Q And finally on this line, could you turn to Exhibit I-9?

12 A (Complying.)

13 Q Do you recognize this as the Revised Articles of the Medical
14 Service Corporation of Spokane as a - as revised in November
15 1994?

16 A Yes.

17 Q Now, turning again to the second page under Article 3, do
18 you see a statement of corporate purpose appearing there?

19 A Yes, there is the intent of the purpose and articles of
20 incorporation.

21 MR. MADDEN: Offer I-9, Your Honor.

22 MR. MITCHELL: No objection.

23 MS. deLEON: No objection.

24 JUDGE FINKLE: Admitted.

25 Q (BY MR. MADDEN) Mr. Marquardt, if you know, as of November

1 21st, 1994, when these revised articles that were Exhibit
2 I-9 that were filed with the Secretary of State, was the
3 Medical Service Corporation part of the Premera group?

4 A You know, I don't really remember when the affiliation
5 started, if it was at that time or not, so I don't have an
6 exact date of the --

7 Q Fair enough.

8 Let's - let's turn back then to Exhibit I-4, the long
9 form tax opinion. And if I could direct your attention to
10 Page 60 of that document. The first complete sentence at
11 the top of that - of Page 60 state, "The issuance of the
12 membership interest to the foundation represents solely a
13 change in the structural format of Premera because the
14 purpose in the mission of the foundation as a charitable
15 nonprofit organization will be identical to the purpose and
16 mission of Premera groups."

17 Do you see that?

18 A Yes.

19 Q To your knowledge, has anyone at Premera inquired of Ernst &
20 Young as to the materiality of that statement to its tax
21 opinion?

22 A Well, that statement is not in the P-64 final document, so I
23 don't think it is material to the tax opinion.

24 Q Have you asked?

25 A Well, we presented what the actual facts and circumstances

1 were and we got the tax opinion from E & Y.

2 Q We got a short form.

3 A Well, it is all that is required.

4 Q Okay. And you don't know whether - whether Premera, with
5 respect to this specific statement, informed Ernst & Young
6 that it was wrong?

7 A Well, it is not in the final document, so, yeah, I think we
8 did.

9 Q You think?

10 A Well, it is not in there, so I would assume that we did. I
11 can't tell you verbatim that that was a point of discussion.

12 Q Do you - do you assume the same, with respect to the second
13 sentence of the first full paragraph on Page 60, which says,
14 "The issuance of the stock interests by New Premera to the
15 foundation will represent solely a continuation of the
16 general structure of Premera in the form of New Premera
17 because the purpose and mission of the foundation as a
18 charitable nonprofit organization will be identical to the
19 purpose and mission of the Premera group"?

20 MR. MITCHELL: I'm sorry. What was the question?

21 Q (BY MR. MADDEN) Do you assume that someone unknown at
22 Premera informed Ernst & Young that that statement was
23 incorrect?

24 A Well, I will tell you that it is not in the facts and
25 circumstances of what was presented in P-64 in the

1 representations that we made to Ernst & Young.

2 Q And did you decide to take that out after it came to your
3 attention that someone might suggest at this hearing that
4 those statements were inconsistent with the company's
5 position on other issues?

6 A No, we just decided that it does not apply to the facts and
7 circumstances that were in play.

8 Q Finally, Mr. Marquardt, let me just direct your attention to
9 the statement at the bottom of Page 60 in Exhibit I-4 which
10 says, "The New Premera group will not alter its geographic
11 scope of coverage, therefore the continuity of the interest
12 requirement will be satisfied."

13 MR. MITCHELL: Where are you?

14 A Where are you? I'm sorry.

15 Q (BY MR. MADDEN) I'm at the bottom of Page 60, the very last
16 clause and complete sentence.

17 A Okay.

18 Q That's another representation that does not appear in P-64;
19 correct?

20 A You know, I don't have those memorized, so I can't say for
21 sure, but I don't believe it is.

22 Q Is that because it is inaccurate?

23 A I mean, we have no intents to change our geographic scope of
24 coverage.

25 Q I'm done with that exhibit for now, Mr. Marquardt.

1 Did you say in response to a question from Ms. deLeon
2 that the Healthy Options and Basic Health Plan lines of
3 business were net positive for the company?

4 A I don't believe that came up in discussions.

5 Q Forgive me.

6 Were they - were those lines generators of positive
7 revenue for the company?

8 A The Healthy Options Basic Health Plan business is currently
9 generating positive income results.

10 Q Is it the case, therefore, that the company decided to drop
11 those lines because they were not sufficiently profitable,
12 if you will?

13 A Well, one, we didn't drop those lines to start with. We
14 have arranged to transfer the business to Molina Company -
15 or Corporation. And the reason that we did that was that we
16 do not believe long-term that the funding for those lines
17 will be appropriate and that it will be problematic in the
18 future. And we had an opportunity to transfer to the Molina
19 Corporation and we seized that opportunity.

20 MR. MADDEN: No further questions.

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REDIRECT EXAMINATION

BY MR. MITCHELL:

Q Mr. Marquardt, let me first ask you about Exhibit I-4, about which Mr. Madden inquired.

To the best of your knowledge, did Ernst & Young base its analysis and its supposed recommendations in this document upon information provided by Premera?

A To the best of my knowledge, that is not the case.

Q You say - you testified, I believe, Mr. Marquardt, that you have reviewed this document although not in the context of this proceeding.

Based upon that review, can you tell me whether the representations set forth in Exhibit I-4 are accurate?

A No, they are not.

Q I take --

A They --

Q I'm sorry.

A They do not represent the real facts and circumstances of the transaction.

Q I take it you have also reviewed the representations in Exhibit P-64; is that correct?

A Yes, I have.

Q Indeed, some of those representation letters bear your signature, do they not?

1 A Yes, they do.

2 Q And are the representations in Exhibit P-64 accurate?

3 A Yes, they are.

4 Q Do they reflect Premera's understanding of the facts and
5 circumstances of its origins, its current business and its
6 future plans?

7 A Yes, they do.

8 Q You, I think, testified, Mr. Marquardt, that there is a
9 technical memorandum that is to accompany the opinion that
10 is in Exhibit P-64; is that correct?

11 A That's correct.

12 Q Have you reviewed drafts of the technical opinion?

13 A Yes, I have.

14 Q Is there anything in the technical opinion draft that you
15 have reviewed which is consistent with the representations -
16 well, let me try this over again.

17 Is there anything in the technical memorandum that you
18 have reviewed that is inconsistent with the representations
19 set forth in Exhibit P-64?

20 A No. They are identical.

21 Q Mr. Marquardt, has Premera, in the course of this
22 proceeding, ever represented to anyone that it is a charity?

23 A No, we have not.

24 Q In the context of the interactions that you had with the PwC
25 tax advisors, Mr. Marquardt, were you at any point asked or

1 instructed to provide to the advisors the actual opinion to
2 be furnished by E & Y and their representations underlying
3 it?

4 A We were asked to have a final opinion before the hearing and
5 that's what we have provided. So we provided the final
6 opinion and representations that are in P-64.

7 Q Did the PwC representatives ask when the representations
8 would be finalized?

9 A I believe they did.

10 Q And what did you tell them?

11 A Prior to the hearing.

12 Q The E & Y opinion, which is in 64, is it based upon
13 representations in Exhibit I-4?

14 A No, it is not.

15 Q What representations is it based upon?

16 A It is based upon the representations that are attached to
17 it, or follow it, in P-64.

18 Q I want to go back to a couple of questions that Ms. deLeon
19 asked you. She said, first of all - I guess inquired, first
20 of all, why it was Premera measured its RBC level by looking
21 at the RBC average of plans nationwide instead of looking at
22 plans locally. Do you recall that question?

23 A Yes, I do.

24 Q And are you familiar with a local Blue plan by the name of
25 Regence?

1 A Yes, I am.

2 Q And is its RBC level in the same neighborhood as Premera's
3 or is it in the neighborhood of the goal that Premera has as
4 a result of the conversion?

5 A It is my understanding that the Regence Blue Shield RBC is
6 over 700 percent.

7 Q Mr. Marquardt, why have you not already firmed up your plans
8 to spend the money that you hope to raise through the IPO?

9 A Well, we have lots of things in the queue and we weren't
10 really certain as to what the timing of the IPO would be and
11 the process, so it seemed - it seemed not to be the most
12 useful part of time to have that firmed up yet. And we have
13 said all along we would firm that up as part of the IPO
14 process.

15 Q Ms. deLeon also asked you about certain of your competitors
16 that are nonBlue entities. Do you recall that question?

17 A Yes.

18 Q In your judgment, Mr. Marquardt, can Premera serve its
19 subscribers as well if it loses the Blue mark?

20 A No. I think we would be significantly damaged if we lost
21 the Blue mark. It would really limit our ability to do any
22 kind of national business or any kind of, you know, local
23 business that had subsidiaries in other markets.

24 Q How about the subscribers, how would they be impacted if
25 Premera were to lose - lose the Blue mark?

1 A Well, we would lose the ability of the Blue card program to
2 be able to travel to other markets and access the local Blue
3 networks.

4 Q Would Premera proceed with this conversion if the price was
5 the loss of a Blue mark?

6 A Absolutely not.

7 Q With respect to the points in dispute that we talked about
8 in the context of the transaction terms and, in particular,
9 in the context of the issue of whether the voting trust
10 should survive, Mr. Marquardt, will you - first of all, were
11 you present in the discussions with the consultants that
12 took place from December of last year through January of
13 this year?

14 A Yes, I was.

15 Q In the discussions over this issue, which I gather was one
16 of the "Magnificent Seven," indeed the only one of the
17 "Magnificent Seven" that you could not resolve, did the
18 consultants seem to you to be concerned about the benefits
19 to or the potential harm to the subscribers of Premera or
20 rather to be concerned about what they perceived to be
21 marginal value to the foundation?

22 A Well, it is my understanding that the arguments presented by
23 the consultants was in regards to the foundation, that if
24 the - if the mark would go away, the foundation would be a
25 significant shareholder, that then the voting trust

1 arrangement should go away for that shareholder. So they
2 didn't really make an articulate case about the protection
3 of the subscriber.

4 Q Is the protection of the subscribers an issue to be
5 considered in the context of this question, Mr. Marquardt?

6 A We believe it is. We believe at that point in time if the
7 mark were to go away, as remote as it may seem to be, we
8 want to have a board that is experienced in running an
9 insurance company, not a board experienced in running a
10 foundation stepping in and making decisions.

11 Q There was a question about the Dimensions product and the
12 fact that Premera was able to make a significant investment
13 in the Dimensions product notwithstanding its capital
14 constraints, Mr. Marquardt.

15 A Yes.

16 Q What would have been the impact on RBC had Premera
17 endeavored to invest in Dimensions but not had the sale
18 lease-back arrangements available to it that it used in that
19 particular investment?

20 A Yes. If we would not have been able to do the series of
21 sale lease-back transactions, our current RBC that is now at
22 433 would be below 350. So it would have put us on the
23 early warning list and put us in a very constrained
24 position.

25 Q Do you have any assurance, Mr. Marquardt, that the kind of

1 sale lease-back arrangements that you were able to enter
2 into with respect to the Dimensions product will be
3 available for future capital investments?

4 A No, I do not.

5 Q There was a questions raised about the first board of the
6 foundation, which I believe you testified was appointed by
7 Premera and you said that indeed the first board is already
8 making application to receive recognition from the IRS.

9 Do you recall that?

10 A Yes.

11 Q Was it a recommendation by the OIC staff's consultants that
12 the foundations should obtain recognition from the service
13 of their tax exempt status as soon as possible and in any
14 case before the proposed conversion?

15 A I believe it was.

16 Q Ms. deLeon asked you about the profitability of various
17 lines of business that Premera currently conducts and you
18 explained, I believe, the notion of covering variable costs
19 and making a contribution to fixed overhead.

20 Do you recall that testimony?

21 A Yes.

22 Q My question to you is this, Mr. Marquardt: Do either
23 businessmen or investors in a company look at the
24 profitability of the company by product line or on a
25 portfolio basis?

1 A Well, we believe people look at a portfolio basis. And we
2 run our business on a portfolio basis. We do better than
3 expected in some lines and do worse than expected in some
4 lines and that not every line will be at optimal
5 profitability.

6 Q You testified I believe in response to another of
7 Ms. deLeon's questions that the intent of Premera was to
8 transfer 100 percent of the initial stock to the foundation
9 at the point of conversion.

10 Do you recall that testimony?

11 A Yes, I do.

12 Q Is it your understanding, Mr. Marquardt, that the stock to
13 be transferred at that point is unrestricted, only
14 unrestricted or subject to the restrictions that are set
15 forth in the Form A documents?

16 A Well, the stock would be subject to the restrictions set
17 forth in the documents.

18 Q I believe you testified that you expect in your projections
19 that Premera will grow top-line revenue by 15 percent a
20 year; is that correct?

21 A That's correct.

22 Q Does that reflect a 15 percent membership growth or some
23 other phenomenon?

24 A It reflects a healthcare cost trend of 10 to 11 percent, but
25 it is a combination of providing unit cost increases and

1 utilization increases. And then it reflects a membership
2 growth of four percent roughly on the insured business and
3 five percent on the self-funded business. And those are
4 annual numbers.

5 Q Ms. deLeon also asked you about the cost of conversion and I
6 believe you testified that the most recent figure is 31
7 million dollars; is that right?

8 A That's correct.

9 Q Of that 31 million dollars, Mr. Marquardt, how much do the
10 state's consultants account for?

11 A Eighteen million.

12 Q You were also asked by Ms. deLeon about the board's
13 responsibility at Premera. And my question to you is this:
14 What is the board's focus and management's focus in terms of
15 pursuing the mission of Premera?

16 A Well, the board's focus is delivering on the mission - the
17 board and management's focus is on delivering the mission of
18 Premera whether we are for-profit or not-for-profit.

19 Q And what is that mission?

20 A Provide peace of mind for the members about their healthcare
21 coverage.

22 MR. MITCHELL: Nothing further.

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RECROSS-EXAMINATION

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BY MS. deLEON:

Q You just said that Regence's RBC is approximately 700 percent; is that correct?

A I believe it is over 700 percent. I don't have an exact number on it.

Q Regence is a nonprofit, right?

A That's correct.

Q Do you know the average RBC of for-profit health carriers?

A No, I don't.

Q If Premera doesn't have a list of things to do immediately after the IPO with all the money that it gets, wouldn't it be possible to raise less capital at the IPO and then actually raise more when you decide on how you want to spend it?

A Well, I think that's possible. The intent is that we are working on those plans right now in hopes that the conversion is approved and that we go forward with an IPO. And I would suggest that - or I would hope that we would be ready to have that for the IPO.

Q At some point after the Commissioner makes his decision, you will come up with a list of to-dos?

A Yeah. The initial plan was to do this as part of the IPO process, which we would do with input from our bankers and

1 from the state's consultants.

2 Q But that would be after the Commissioner's decision?

3 A Right. It would be in deciding what the size of the IPO
4 should be, which would include a portion for the company and
5 a decision whether the foundations wanted to put some shares
6 into the initial IPO.

7 Q And you also just spoke that loss of the Blue mark would
8 impact your ability to compete basically?

9 A Yeah. I think it would be a drastic impact on the company.

10 Q However, I believe Ms. Donigan testified that for the
11 Washington Mutual business, the Blue mark didn't get you the
12 business.

13 A Well, I'm not sure that it was - we didn't get the business
14 because of the Blue mark. I think we got people's attention
15 because we had the Blue mark and could provide the Blue
16 network across the country.

17 I think the real concern on Washington Mutual was that
18 we didn't have the integrated service capabilities that
19 United and Aetna have.

20 Q So it is a total package, not just the Blues mark --

21 A Correct.

22 Q -- to get business?

23 A Sure it is.

24 Q Is it correct to say that if you grew the ASC business, it
25 would not impact your RBC; correct?

1 A It would have less impact than the insured business because
2 there are some factors that go into the calculation, but it
3 is not as much as the insured line.

4 Q So you could continue to do that regardless of the
5 conversion and not have the negativity impact your RBC?

6 A Yeah, in theory. I think hypothetically you could. I
7 think, you - you know, we want to grow segments of the
8 business, if we could, though.

9 MS. deLEON: No further questions.

10

11 RECROSS-EXAMINATION

12

13 BY MR. MADDEN:

14 Q Mr. Marquardt, Premera chose Ernst & Young as its tax
15 advisors; correct?

16 A That's correct.

17 Q Did Premera task individuals within the company to be
18 liaisons with Ernst & Young?

19 A Yes.

20 Q Who?

21 A John Domeika was the principle liaison.

22 Q And, for the record, Mr. Domeika's position is what?

23 A General counsel.

24 Q And Premera also provided the relevant documents to Ernst &
25 Young; is that correct?

1 MR. MITCHELL: Object to the question as lacking
2 content. Relevant to what?

3 MR. MADDEN: Relevant to the task for which Premera
4 hired Ernst & Young.

5 A Well, Ernst & Young had history with us. They have been our
6 tax advisors for a number of years, so I think they have had
7 access to a number of documents and history of the company.
8 They helped us file tax returns for, you know, five, six
9 years at least.

10 MR. MADDEN: Thank you. No further questions.

11 MR. MITCHELL: Brief redirect.

12

13 REDIRECT EXAMINATION

14

15 BY MR. MITCHELL:

16 Q Mr. Marquardt, you testified in response to Ms. deLeon's
17 question that you would anticipate that the potential size
18 of the IPO with the uses of capital that might be raised
19 thereby and so forth would be done in - as part of the
20 process leading up to the IPO; is that right?

21 A That's correct.

22 Q In conjunction with investment bankers, including those
23 representing the foundations; is that right?

24 A That's correct.

25 Q Is that a typical process for a company going to an IPO,

1 Mr. Marquardt?

2 A Yeah, I believe it is. I mean, we have an idea of what we
3 would like, but it is going to depend on what the market
4 conditions are at the time as to what the size of the IPO
5 should be.

6 Q Are you familiar with the concept of an IPO procedures
7 opinion, Mr. Marquardt?

8 A Yes.

9 Q Can you explain the function of the IPO procedures opinion
10 as it is proposed to be used here?

11 A I believe it is to see if there were any kind of material
12 changes in the operations of the company from the time of
13 conversion approval down to the IPO date or shortly
14 therebefore.

15 Q Is it your understanding, Mr. Marquardt, that the IPO
16 procedures opinion is to be issued by the OIC staff's
17 consultants to the Commissioner prior to the conversion
18 becoming effective?

19 A That's my understanding.

20 Q And does the IPO procedures opinion, as you understand it,
21 address the issues such - such issues such as timely and
22 pricing and the like?

23 A I believe it does.

24 MR. MITCHELL: Nothing further.

25

RECROSS-EXAMINATION

BY MS. deLEON:

Q Have you participated in an IPO in the past?

A No, I have not.

MS. deLEON: Thank you. No questions.

MR. MADDEN: No questions.

EXAMINATION

BY COMMISSIONER KREIDLER:

Q Mr. Marquardt, let me just ask a couple of questions here that have come to mind as I have listened to your testimony.

First, there was the hypothetical if the Blues mark went away, and I fully appreciate the hypothetical nature of that and what it would mean to the question of Premera wanting to proceed with the Form A filing for conversion, but if the - if the board members that were being appointed through the foundations were experienced in running an insurance company, would that still be problematic or not?

A Well, I think you are - you are looking at kind of two different criteria. One, the insurance company is - you are looking for kind of general business experience and financial experience to run the foundation. I would think that - obviously I'm not going to have impact on this, but I

1 would think that you would want to have people experienced
2 in grant making and helping the community.

3 Q I was thinking more for the Premera board itself, that the -
4 that the appointing board members to Premera in the event
5 that the - that the Blues mark was lost and the reservations
6 of the Blues Association were essentially removed and the
7 board members were being appointed by Premera for - by the
8 foundation for Premera, would that be problematic?

9 I mean, if they went to a process of who they appointed
10 to Premera's board that following a practice not, for
11 example, too dissimilar from the standpoint of board member
12 selection, would that be problematic for Premera?

13 A Well, I - I am not an expert on quite how the board
14 appointment process will work going forward as a public
15 company, but I believe it would go to shareholder vote and
16 then it is a question of how are those shares voted. So I
17 am probably not in a great position to answer your question.

18 Q Okay. One of the items that you - that you mentioned in
19 your testimony were admin- - one of the areas that you
20 could - would essentially raise capital would be by reducing
21 the administrative costs.

22 Can you give me any idea of the operational efficiencies
23 as a percentage over, let's say, current administrative
24 costs that you hope to achieve through conversion?

25 A Well, I don't think I tie it directly to conversion. I

1 think, you know, we were going to continue to drive
2 operational efficiencies whether we convert or not. I think
3 the opportunity we have is to do that a little quicker, do
4 it a little better and have a little higher probability of
5 success in making that happen.

6 So the conversion itself, I can't give you an exact
7 number of what the impact from an operational improvement
8 would be.

9 Q Any targets that you would be shooting for in the way of
10 percentages?

11 A Well, I think overall we continue to - and we look at it as
12 trying to flatten our per member per month cost. And our
13 objective is to flatten that cost over the next three years
14 so that it runs steady and it's not inflating on any
15 inflationary rate.

16 Q And that would be essentially a positive at that point, I
17 mean, a percentage reduction?

18 A It would result in a percentage of total revenue reduction
19 from doing that, but I don't have that exact number.

20 Q Probably largely driven because of the rising cost of
21 healthcare?

22 A Well, a combination, but, you know, if we don't have
23 inflation on our G & A - or our General administrative
24 costs, that it does have an impact and I think that would be
25 a great outcome for us.

1 Q An earlier issue that went back and forth here several times
2 - and I'm probably missing some of the nuances that are
3 involved here - but it would appear to me that if you
4 offered 100 percent of the initial stock offering, that
5 essentially represents 100 percent of the initial stock
6 offering would be turned over to the foundations, if that
7 does equate to essentially the value of Premera; am I
8 correct in that assumption?

9 A Well, value is a very nebulous concept and we - we can get
10 into a very theoretical argument about what value is and
11 isn't. I tried to explain that in the normal transaction
12 where you have a buyer and seller you can initially agree to
13 what value is.

14 Here by giving 100 percent of the stock, you might get
15 to that point and that might be a valid point to get to, but
16 the value will be realized as - as the stock is liquidated
17 in the public market and will give you the true final value,
18 if you will.

19 Q Let me - one of the - one of the items that you put up at
20 the beginning was - you had the initial graph, I believe it
21 was. It listed three reasons for conversion. I believe the
22 first one was for, so to speak, financial challenges that
23 you may face. I think the second one was to be able to grow
24 the company. And the third one was, so to speak, new
25 initiatives that you would like to undertake.

1 In fact, there is the graph itself. And I'm curious
2 were those in order of importance for seeking new capital?

3 A Well, I think the first one is, that we want to be able to
4 strengthen our reserves to meet current and future
5 obligations to our subscribers. And along with that is to
6 protect against certain economic uncertainties. That kind
7 of goes with that. And that is really making sure that we
8 are capitally strong for our subscribers.

9 I might actually flip the second and third one and talk
10 more about the additional things that we could do from an
11 infrastructural product to better service our customers
12 because I think that will drive the potential future growth
13 of the company.

14 Q One last question that came up relative to a question that
15 was asked relative to any discussions that may have taken
16 place about other options that may have been available to
17 Premera short of - along with conversion, which would be
18 whether you merged with another company or you were acquired
19 by another company.

20 I believe you indicated that there had been - there were
21 no proposals, but were there any discussions that took place
22 as a part of, so to speak, due diligences to other options
23 that you might want to at least discuss?

24 A It was brought up as an alternative in board discussions and
25 the board - and I think Ms. Jewell clearly articulated - the

1 board would prefer to remain as an independent organization
2 at this time.

3 Q Is that something that you could assume is clearly off the
4 table, that only conversion is the item that is before us
5 and that there is no reason to go back to the other items at
6 this time?

7 A That's our intent.

8 COMMISSIONER KREIDLER: Thank you very much.

9 MS. deLEON: No further questions.

10 MR. MADDEN: No questions.

11 JUDGE FINKLE: Thank you. Please step down.

12 MR. MITCHELL: Premera calls Rick Fox.

13

14 RICHARD FOX, having been first duly
sworn by the Judge,
testified as follows:

15

16 JUDGE FINKLE: Please sit down.

17

18 DIRECT EXAMINATION

19

20 BY MR. MITCHELL:

21 Q Mr. Fox, could you please state your name for the record?

22 A Richard P. Fox.

23 Q Tell us a little bit about your business and professional
24 background, Mr. Fox.

25 A Yes. I graduated from college in Ohio University in 1969.

1 I started with Ernst & Young as an auditor in that same year
2 in the Cleveland office. I transferred from there in 1976
3 to Sao Paulo, Brazil with Ernst & Young.

4 In 1982 I transferred to the Seattle office. I was with
5 the Seattle office until 1997 and was the managing partner
6 when I left Ernst & Young. After that I have worked for
7 three different companies in financial roles, PACCAR, Wall
8 Data, and CyberSafe. I also was - I'm currently a
9 consultant with a small consulting firm we call RavenFire.
10 There is nine of us in the firm. I'm a senior partner.

11 Q What is your connection with Premera and Premera Blue Cross,
12 Mr. Fox?

13 A I'm on the board of directors of Premera and Premera Blue
14 Cross.

15 Q What other organizations are you currently active in?

16 A I serve on three other boards. I'm on the board of
17 aQuantive, an Internet marketing company. I'm on the board
18 of Shurgard Storage - Storage Company. I'm also on the
19 board of Flow International.

20 I serve as the treasurer and I'm on the board of the
21 Seattle Foundation. I'm also on the Board of Visitors of
22 the Fuqua School of Business at Duke University.

23 Q Mr. Fox, have you provided prefiled direct testimony in that
24 matter?

25 A I have.

1 Q Do you adopt that testimony?

2 A I do.

3 MR. MITCHELL: Your Honor, with Mr. Fox's adoption
4 of his testimony, which is Exhibit P-57, we would move for
5 the admission of that testimony.

6 MS. deLEON: No objection.

7 JUDGE FINKLE: Admitted.

8 Q (BY MR. MITCHELL) Would you please - first a preparatory
9 question, do you serve on any committees of the Premera
10 board?

11 A Yes. I'm on the - I'm I - I chair the audit compliance
12 committee and I'm a member of the investment committee.

13 Q Would you please describe the charter and operations of the
14 audit and compliance committee of the Premera board of
15 directors?

16 A Yes. The audit committee provides oversight of several
17 areas within the company including the systems of internal
18 controls, the financial reporting within the company and
19 also it oversees the compliance group, which is responsible
20 for compliance with the law and with the ethics program of
21 the company.

22 We also have regular meetings with the internal audit
23 department of Premera, the external audit department, the
24 compliance department, of course, the office of the CFO.

25 Q Having described the charter and operations in descriptive

1 terms, Mr. Fox, what conclusions should be drawn from the
2 work of this committee and its function within the Premera
3 operation?

4 A Well, I have been on the board of Premera and I have served
5 on the audit committee since the year 2000. I have been - I
6 have been chair of the committee for the last year, since
7 May of last year. We are a committee that is very much
8 focused on best practices in the way of audit committees.
9 We view ourselves - although we are not a public company, we
10 view the company as having public accountability and
11 therefore we strive to comply with all - all rules,
12 regulations and best practices relating to audit committees.

13 Q Mr. Fox, do you have confidence in the competence,
14 experience and integrity of Premera's management?

15 A I do.

16 Q Why --

17 A I'm of the view that one of the most important things that
18 the audit committee does is oversee what I call the "tone at
19 the top," the integrity of the senior management of the
20 company.

21 I have come to, over my years involved with the company,
22 have a high degree of respect and take great comfort in the
23 integrity of the senior management of Premera.

24 Q You said, I think, Mr. Fox, that you were on the board of
25 some public companies; is that right?

1 A Yes.

2 Q Is Premera prepared for the challenges of being a public
3 company?

4 A Absolutely. We have taken very seriously the - the decision
5 to seek conversion to for-profit. And we have had the
6 intervening period to take the opportunity to do everything
7 we can to make sure that the company is prepared to be a
8 public company. That includes following all of the
9 Sarbanes-Oxley's rules. And we are in the process of
10 implementing all the rules, in many cases ahead of schedule
11 as required by Sarbanes-Oxley.

12 We have complied with the Blue ribbon committee on best
13 practices for audit committees. We have even gone so far as
14 we now do the - the company is doing mock 10-Qs and mock
15 10-Ks so we are fully ready for compliance when and if the
16 company is a public company.

17 Q Mr. Fox, what is your assessment of Premera's current
18 capital position and its capital needs?

19 A Well, the capital has been something that the board, and
20 especially the audit committee, has focused on consistently.
21 I certainly became well aware of the capital situation of
22 the company soon after I joined the board. And I think it
23 is something that certainly concerns me, that we aren't - we
24 don't have a higher capital base.

25 I think that having a base in the 500 to 600 percent RBC

1 would be ideal for this company. I think it gives it some
2 flexibility that it doesn't otherwise have. And it
3 certainly is in the best interest of our members.

4 Q Why do you and the other members of the board support
5 conversion notwithstanding the time and effort that it has
6 taken you to get to this point?

7 A Well, I think that certainly the capital is a prime concern
8 and I think that having considered various other
9 alternatives, the board concluded that this was the most
10 practical way to raise the capital base of the company.

11 I think it is important to understand that this is not a
12 one-time event. That if - if we are - if we are a
13 for-profit company, we will have access to capital markets
14 in the future should we ever need those as well.

15 In addition, we think that the new capital that would
16 come to the State of Washington and State of Alaska in the
17 form of foundation funds would be beneficial to the
18 population of those states.

19 MR. MITCHELL: Nothing further. Thank you.

20
21 CROSS-EXAMINATION

22
23 BY MS. deLEON:

24 Q Can you tell me how the board came to the 500 to 600 percent
25 range?

1 A Well, I think, as Mr. Marquardt demonstrated, we have been -
2 we have been looking at this very carefully. And at each
3 board meeting and in each audit committee meeting, we look
4 at what the RBC is. We look at the company's forecast of
5 RBC going forward.

6 And we also compare it to what we believe are our
7 comparable company's capital structures, you know, in the
8 Blue plans. And we came to the conclusion that that was a
9 reasonable level of capital for this company. There is
10 nothing magic about 500 to 600, but using that as - as a
11 benchmark, it puts us in a position where we were very
12 competitive with peer companies.

13 Q Would Regence be one of your peer companies?

14 A Absolutely.

15 Q And it is approximately 700 percent, according to
16 Mr. Marquardt?

17 A According to Mr. Marquardt, it is in excess of 700 percent.

18 Q And it is a nonprofit; correct?

19 A It is a nonprofit, that's correct.

20 Q Do you know what projects could be funded after the
21 conversion that have not been funded currently?

22 A Well, without - without being specific as to that, I think
23 that there are a number of projects that we as a board have
24 looked at as things that would certainly improve the
25 operating efficiencies of the company and would be important

1 to our - to future growth in providing better service to our
2 members.

3 You know, I think a lot of those would be involved in
4 the information technology area, but there is also some
5 things in what our offerings are to our members that could
6 be funded if we had additional capital. But above and
7 beyond that, as others have testified, there is no specific
8 plan as to how the funds will be used.

9 Q So the board agrees with the initial investment of the funds
10 into bonds until they figure out what projects they want to
11 fund?

12 A Well, the - all funds of the - of the company that aren't
13 otherwise being utilized are invested in accordance with an
14 investment policy and that's overseen by our investment
15 committee. So, yes that would be what would happen to any
16 funds that weren't immediately put to use.

17 Q We talked about the RBC levels and we know approximately the
18 RBC for Regence is about 700 percent. Do you know what the
19 average RBC level is for - for a for-profit health carrier?

20 A No, I don't. I only know what Mr. Marquardt - only saw what
21 Mr. Marquardt presented this morning.

22 Q So how would you know if the 500 or 600 percent is
23 competitive?

24 A Well, I think Mr. Marquardt showed some Blue Cross/Blue
25 Shield statistics and I certainly don't think that there

1 would be any reason why the RBC would be any different for
2 for-profit or not-for-profit. It is the capital base of the
3 company.

4 Q It says here in your prefiled direct testimony that - and I
5 will - it is on Page 7, that Premera management dealt with -
6 deals with internal audit functions and they address
7 findings and recommendations raised in the audit reports; is
8 that correct?

9 A Yes.

10 Q Okay. And one of those recommendations was that the company
11 should establish a more extensive business continuity plan?

12 MR. MITCHELL: Excuse me. May I approach and give
13 the witness a copy of his testimony that he has been read
14 from?

15 MS. deLEON: I'm not actually reading it. I'm
16 paraphrasing it. I'm assuming he is familiar with the
17 testimony, but that's fine.

18 JUDGE FINKLE: Again, I think that's fine to give
19 him a copy anyway.

20 A Sorry. Where were you?

21 Q (BY MS. deLEON) Page 7. You talk about an extensive
22 business continuity plan.

23 A That was meant as an example of - of an issue that was
24 raised by our internal audit group. And are you familiar
25 with the term business continuity.

1 Q Is that the disaster recovery plan?

2 A In part. It is more encompassing than just simply disaster
3 recovery, but, yes, that would be another term that would
4 somewhat be synonymous, but it is a very significant
5 undertaking.

6 It has taken a lot of time and the company has taken
7 very seriously that written recommendation and has been
8 working over a period of time to correct it. And we are
9 making excellent progress on it. We just had our last
10 meeting and had a report on - on the milestones reached with
11 respect to the business continuity plan.

12 Q So that's a project that is currently funded and underway?

13 A Yes.

14 MS. deLEON: I have no further questions.

15 MR. MADDEN: No questions.

16 MS. HAMBURGER: No questions.

17 MR. MITCHELL: No redirect.

18 COMMISSIONER KREIDLER: No questions.

19 JUDGE FINKLE: Thank you. Please step down.

20 MR. MITCHELL: Would you like us to call another
21 witness or shall we call it quits?

22 JUDGE FINKLE: Give us a little report about where
23 you stand and maybe that will help us to decide.

24 MR. MITCHELL: We have one witness to go, Mr. Steel.

25 JUDGE FINKLE: And what is your expectation about

1 how long Mr. Steel will take?

2 MR. MITCHELL: My expectation will be probably 30
3 minutes for direct.

4 MS. deLEON: Your Honor, I think we have about an
5 hour of cross.

6 MR. MADDEN: Less than them and how much depends on
7 what they cover, but my intention is half-an-hour or less.

8 JUDGE FINKLE: Why don't we go ahead and break.
9 Where does that leave us? It is just a bit of a slide,
10 I think, from what we might have hoped. I thought I
11 understood you were hoping or expecting to rest today.

12 MR. MITCHELL: Tuesday morning was our estimate.

13 JUDGE FINKLE: Tuesday morning. I stand corrected.
14 So we are looking good.

15 And did you want to meet at 8:45, is that the idea, on
16 some procedural issues?

17 MR. MITCHELL: To address some exhibits and one
18 other procedural issue.

19 JUDGE FINKLE: Okay. We will see you 8:45.

20

21 (Proceedings adjourned.)

22

23

24

25

C E R T I F I C A T E

I, KRISTIN D. MANLEY, a court reporter in the State of Washington, do hereby certify that I was present during the foregoing matter and reported said proceedings stenographically.

I, DO FURTHER CERTIFY that the foregoing transcript constitutes a full, true, and accurate transcript of that portion of my stenograph notes so taken and so ordered.

I, DO FURTHER CERTIFY that I am not related to any of the parties to this lawsuit, nor am I interested in the outcome thereof.

Dated this 12th day of May, 2004.

KRISTIN D. MANLEY

CCR NO. 2211